

# The Sale of Business Doctrine: New Relief from Securities Regulation or a New Haven for Welshers?

ROBERT A. PRENTICE \*  
MARK E. ROSZKOWSKI \*\*

## I. INTRODUCTION

Since passage of the Securities Act of 1933<sup>1</sup> and the Securities Exchange Act of 1934,<sup>2</sup> there has been a continuing controversy concerning the scope of their coverage. The Acts contain many joints that Congress left loosely connected by which, through liberal or restrictive interpretation, the Court can expand or restrict the coverage of the securities laws.<sup>3</sup>

One key joint exhibiting substantial play is the definition of a security in the '33 and '34 Acts.<sup>4</sup> The Supreme Court has often been required to determine whether particular instruments were securities.<sup>5</sup> Yet it would probably surprise members of the Congress who passed the '33 and '34 Acts that the

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\* B.A., 1972 University of Kansas; J.D., 1975 Washburn University. Assistant Professor of Business Law, University of Texas, Austin.

\*\* B.S., 1971 University of Illinois; J.D., 1975 University of Illinois. Assistant Professor of Business Law, University of Illinois at Urbana-Champaign.

1. 15 U.S.C. §§ 77a-77bbb (Supp. V 1981) [hereinafter the "'33 Act'"].

2. *Id.* §§ 78a-78kk [hereinafter the "'34 Act'"].

3. Whether the Acts are expanded or restricted in coverage appears to depend largely on the composition of the Supreme Court at the time the issue is addressed. Compare the decisions with a strong flavor of the Warren Court in *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964) (expansive interpretation of doctrine of implied rights of action), and *Superintendent of Ins. v. Bankers Life & Cas.*, 404 U.S. 6 (1971) (liberal construction of "in connection with" requirement of § 10(b) of '34 Act), with the Burger Court opinions in *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979) (restrictive view of implied rights doctrine), and *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (strict view of "purchaser or seller" requirement of § 10(b)).

4. According to § 2(1) of the '33 Act, 15 U.S.C. § 77b(1) (Supp. V 1981),

The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Section 3(a)(10) of the '34 Act, 15 U.S.C. § 78c(a)(10) (Supp. V 1981), contains a similar definition. The Supreme Court has held that the '33 and '34 Act definitions of a security may be considered functional equivalents. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 847 n.12 (1975); *Tcherepnin v. Knight*, 389 U.S. 332, 335-36, 342 (1967). Indeed, the legislative history of the '34 Act indicates that its definition of security is "substantially the same as the Securities Act of 1933." S. REP. NO. 792, 73d Cong., 2d Sess. 14 (1934).

5. *E.g.*, *Marine Bank v. Weaver*, 455 U.S. 551 (1982) (certificate of deposit and guaranty agreement held not to constitute securities); *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551 (1979) (securities laws held not to apply to a noncontributory, compulsory pension plan); *United Hous. Found., Inc. v. Forman*, 421 U.S. 837 (1975) (instrument denominated "stock" that was in the nature of a recoverable security deposit on a cooperative apartment held not to be a security); *Tcherepnin v. Knight*, 389 U.S. 332 (1967) (withdrawable capital share in a savings and loan association held to be a security); *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967) ("Flexible Fund" annuities held to be securities); *SEC v. Variable Annuity Life Ins. Co. of Am.*, 359 U.S. 65 (1959) (variable annuities held to be securities); *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) (interest in citrus grove development held to be a security); *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943) (interests in oil and gas leases held to constitute securities).

next case the Supreme Court hears regarding the definition of a security may concern regular corporate common stock—the prototypical security.<sup>6</sup> This unusual scenario will occur when the Supreme Court takes the opportunity to resolve the split among the circuit courts regarding the validity of the “sale of business” doctrine.

Sale of an ongoing business is a fairly common occurrence. When the transaction takes the form of a sale of assets, there is little question that no security has been sold. When the business is incorporated, however, and the transaction concerns only the sale of a controlling number of shares of the corporation, it was once generally assumed that securities had been sold, thus bringing the transaction within the scope of the securities laws.<sup>7</sup> The sale of business doctrine challenges this assumption by stating that the transfer of a controlling interest in the stock of an active business corporation to a purchaser who will control or have the right to control the business does *not* constitute the sale of securities.

The notion that corporate stock may, under certain circumstances, be removed from securities law coverage is a controversial one.<sup>8</sup> The number of recent cases discussing the sale of business doctrine indicates the importance of the issue. Although the majority of courts<sup>9</sup> and many commentators<sup>10</sup> view

6. Corporate stock is such a classic example of a security that it is not unusual to see a sale of such stock described as “indisputably covered” by the securities laws. Sonnenschein, *Federal Securities Law Coverage of Note Transactions: The Antifraud Provisions*, 35 BUS. LAW. 1567, 1587 (1980).

7. *E.g.*, *Occidental Life Ins. Co. v. Pat Ryan & Assocs., Inc.*, 496 F.2d 1255, 1261-63 (4th Cir.), *cert. denied*, 419 U.S. 1023 (1974); *Alberto-Culver Co. v. Scherk*, 484 F.2d 611 (7th Cir. 1973), *rev'd on other grounds*, 417 U.S. 506 (1974); *Matheson v. Armbrust*, 284 F.2d 670 (9th Cir. 1960), *cert. denied*, 365 U.S. 870 (1961); *Bailey v. Meister Brau, Inc.*, 320 F. Supp. 539, 543-44 (N.D. Ill. 1970); *Trump v. Badet*, 84 Ariz. 319, 322, 327 P.2d 1001, 1003 (1958).

8. It is interesting that a parallel controversy has arisen regarding whether the stock of a corporation held by a sole shareholder is a security under the Uniform Commercial Code definition in § 8-102. *Compare* *Rhode Island Hosp. v. Collins*, 117 R.I. 535, 537, 368 A.2d 1225, 1227 (holding that it isn't), *with* *Katz v. Abrams*, 549 F. Supp. 668, 671 (E.D. Pa. 1982) (holding that it is); *Wamser v. Bamberger*, 101 Wis. 2d 637, 305 N.W.2d 158 (1981) (holding that it is); *Gross v. Vogel*, 81 A.D.2d 576, 437 N.Y.S.2d 431 (1981) (holding that it is); and *Pantel v. Becker*, 391 N.Y.S.2d 325, 89 Misc. 2d 239 (Sup. Ct. 1977) (holding that it is).

9. *E.g.*, *Sutter v. Groen*, 687 F.2d 197 (7th Cir. 1982); *Kaye v. Pawnee Constr. Co.*, 680 F.2d 1360 (11th Cir. 1982); *King v. Winkler*, 673 F.2d 342 (11th Cir. 1982); *Canfield v. Rapp & Son, Inc.*, 654 F.2d 459 (7th Cir. 1981); *Frederiksen v. Poloway*, 637 F.2d 1147 (7th Cir. 1981); *Chandler v. Kew, Inc.*, 691 F.2d 443 (10th Cir. 1977); *Goodwin v. DeAzoulay*, 534 F. Supp. 1029 (E.D. Pa. 1983); *Kane v. Fischbach*, 1982 [Transfer Binder] FED. SEC. L. REP. (CCH) ¶98,608 (E.D.N.Y. 1982); *Reprosystem v. SCM Corp.*, 522 F. Supp. 1257 (S.D.N.Y. 1981); *Oakhill Cemetery v. Tri-State Bank*, 513 F. Supp. 885 (N.D. Ill. 1981); *Zilker v. Klein*, 510 F. Supp. 1070 (N.D. Ill. 1981); *Anchor-Darling Indus. v. Suozzo*, 510 F. Supp. 659 (E.D. Pa. 1981); *Barsy v. Verin*, 508 F. Supp. 952 (N.D. Ill. 1981); *Dueker v. Turner*, [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶97,386 (N.D. Ga. 1979); *Howard v. Chrysler Corp.*, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶98,306 (D. Colo. 1977); *Bula v. Mansfield*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶96,964 (D. Colo. 1977).

Note that the New York district court cases listed are no longer good authority because of *Golden v. Garafalo*, 678 F.2d 1139 (2d Cir. 1982). The Tenth Circuit's recent decision in *Hackbart v. Holmes*, 675 F.2d 1114 (10th Cir. 1982), applying federal securities antifraud provisions to a two-man corporation, may signal a decision to retreat from the sale of business doctrine. Seymour, *A Sleeping Dragon Awakes: The Federal Securities Laws Apply to One and Two-Man Corporations*, 53 OKLA. B.J. 2531, 2534 (1982).

Several state courts applying state law have also adopted the sale of business doctrine. *E.g.*, *Fox v. Ehrmantraut*, 28 Cal. 3d 127, 615 P.2d 1383, 167 Cal. Rptr. 595 (1980); *Tech Resources, Inc. v. Estate of Hubbard*, 246 Ga. 583, 272 S.E.2d 314 (1980); *Kaiser v. Olson*, 105 Ill. App. 3d 1008, 435 N.E.2d 113 (1981); *Condux v. Neldon*, 83 Ill. App. 3d 575, 404 N.E.2d 523 (1980).

10. Seldin, *New Relief From Securities Regulation?*, MERGERS & ACQUISITIONS, Summer 1982, at 31 [hereinafter cited as “Seldin II”]; Seldin, *When Stock is Not a Security: The “Sale of Business” Doctrine Under*

the sale of business doctrine favorably, a sufficient number of courts<sup>11</sup> and commentators<sup>12</sup> take the contrary position, indicating that the matter deserves careful attention.

Because of the nature of the arguments upon which the sale of business doctrine is built, analysis of its validity requires the divination of legislative intent, careful scrutiny of several Supreme Court opinions regarding the definition of "security," a prescient discussion of the impact of the doctrine's application, and a comparison of the advantages and disadvantages of federal securities regulation itself.

This Article will (1) frame the issue by examining the development and application of the sale of business doctrine and the line of cases opposing it;<sup>13</sup> (2) suggest that the doctrine has many questionable theoretical underpinnings;<sup>14</sup> and (3) conclude that the practical disadvantages of the doctrine outweigh its supposed advantages.<sup>15</sup>

## II. DEVELOPMENT OF THE CONTROVERSY

### A. *Split Among the Circuits*

In the seminal case of *Chandler v. Kew, Inc.*,<sup>16</sup> decided in 1977, plaintiff bought a liquor business by purchasing 100 percent of the owner-corporation's stock. Apparently, the seller's representations about the business were inaccurate, so the plaintiff sued, supplementing his state law claims with federal securities law claims.<sup>17</sup> The Tenth Circuit, utilizing the "economic

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the Federal Securities Laws, 37 BUS. LAW. 637 (1982) [hereinafter cited as "Seldin I"]; Thompson, *The Shrinking Definition of a Security: Why Purchasing All of a Company's Stock Is Not a Federal Security Transaction*, 57 N.Y.U. L. REV. 225 (1982); Comment, *Acquisition of Businesses Through Purchase of Corporate Stock: An Argument for Exclusion from Federal Securities Regulation*, 8 FLA. ST. U.L. REV. 295 (1980).

11. E.g., *Seagrave Corp. v. Vista Resources, Inc.*, 696 F.2d 227 (2d Cir. 1982); *Golden v. Garafalo*, 678 F.2d 1139 (2d Cir. 1982); *Glick v. Campagna*, 613 F.2d 31 (3d Cir. 1979); *Coffin v. Polishing Machs., Inc.*, 596 F.2d 1202 (4th Cir. 1979); *Occidental Life Ins. Co. v. Pat Ryan & Associates, Inc.*, 496 F.2d 1255 (4th Cir.), cert. denied, 419 U.S. 1023 (1974); *Stacey v. Charles J. Rogers, Inc.*, 542 F. Supp. 48 (E.D. Mich. 1982); *Sterling Recreational Org. v. Segal*, 537 F. Supp. 1024 (D. Colo., 1982); *Alma Capital Assocs. v. Wagner*, 532 F. Supp. 591 (S.D. Fla. 1982); *Mifflin Energy Sources v. Brooks*, 501 F. Supp. 334 (W.D. Pa. 1980); *Titsch Printing, Inc. v. Hastings*, 456 F. Supp. 445 (D. Colo. 1978); *Bronstein v. Bronstein*, 407 F. Supp. 925 (E.D. Pa. 1976).

12. The following articles have criticized the sale of business doctrine: Dillport, *Restoring Balance to the Definition of Security*, 10 SEC REG. L.J. 99 (1982); Karjala, *Realigning Federal and State Roles in Securities Regulation Through the Definition of a Security*, 1982 U. ILL. L. REV. 413; Rapp, *Federal Securities Laws Should Protect Some Purchases of All or Substantially All of a Corporation's Stock*, 32 CASE W. RES. L. REV. 595 (1982); Note, *The Purchase of all the Shares of Stock of a Business is not the Purchase of a "Security" Within the Meaning of the Federal Securities Act of 1933 or the Georgia Securities Act of 1973*—Tech Resources, Inc. v. Estate of Hubbard, 30 EMORY L.J. 1212 (1981) [hereinafter cited as Note, *Purchase of Stock*]; Comment, *Securities Regulation—Is Stock A Security?*, 30 U. KAN. L. REV. 117 (1981); Comment, *The Sale of a Close Corporation Through a Stock Transfer: Covered by the Federal Securities Laws?*, 11 SETON HALL L. REV. 749 (1981) [hereinafter cited as Comment, *The Sale of a Close Corporation*]; Note, *Sale of Business by Transfer of 100% of Corporate Stock Not Governed by Securities Laws*, 65 MARQ. L. REV. 487 (1982).

13. See *infra* notes 16-83 and accompanying text.

14. See *infra* notes 84-213 and accompanying text.

15. See *infra* notes 214-297 and accompanying text.

16. 691 F.2d 443 (10th Cir. 1977).

17. The plaintiff claimed violations of §§ 12(2) and 17(a) of the '33 Act. and § 10(b) of the '34 Act. Section 17(a) and 10(b) are the provisions most frequently relied on by plaintiffs in sale of business doctrine cases.

reality" test,<sup>18</sup> summarily informed the plaintiff that although he had purchased corporate stock, he had not engaged in a "security transaction" within the meaning of federal securities laws.<sup>19</sup> In the court's view, the plaintiff was merely buying a liquor store and the stock transfer was merely "an indicia of ownership."<sup>20</sup>

This initial expression of the sale of business doctrine received mixed support in the lower courts during the following few years.<sup>21</sup> The doctrine received its first full explication at the circuit court level in the Seventh Circuit's 1981 decision, *Frederiksen v. Poloway*.<sup>22</sup> In *Poloway*, as in *Kew* and most other cases adopting the sale of business doctrine, the plaintiff was a disgruntled purchaser of a close corporation—in this case the corporation was engaged in selling, servicing, and storing boats. The Seventh Circuit dismissed the plaintiff's federal securities law claims against the seller, holding that the purchase of 100 percent of the stock in an ongoing corporation did not involve the sale of a security.<sup>23</sup>

*Poloway*, *Kew*, and most subsequent cases adopting the sale of business doctrine, were grounded on a particular interpretation of the Supreme Court's opinion in *United Housing Foundation, Inc. v. Forman*.<sup>24</sup> *Forman* held that instruments labeled "stock," which actually were merely receipts for a refundable deposit on an apartment, were not securities within the meaning of the '33 and '34 Acts.<sup>25</sup> The *Poloway* court interpreted this ruling to mean that the "economic realities" underlying a transaction are determinative of whether a sale of securities has occurred.<sup>26</sup> Thus, the presence of a security is gauged not by the label "stock," but by the three-part test set out in *SEC v. W.J. Howey Co.*,<sup>27</sup> which requires (1) an investment in a common enterprise, (2) made with an expectation of profit, (3) with the profit to come solely from the efforts of others.<sup>28</sup> Because the purchaser of 100 percent of the stock of a

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18. *Chandler v. Kew, Inc.*, 691 F.2d 443, 444 (10th Cir. 1977) (quoting *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975), for the proposition that "[b]ecause securities transactions are economic in character Congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto") (emphasis added).

19. 691 F.2d 443, 444 (10th Cir. 1977).

20. *Id.*

21. Cases accepting the doctrine include *Dueker v. Turner*, [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,386 (N.D. Ga. 1979); *Bula v. Mansfield*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,964 (D. Colo. 1977); *Tech Resources, Inc. v. Estate of Hubbard*, 246 Ga. 583, 272 S.E.2d 314 (1980).

Cases rejecting the doctrine include *Mifflin Energy Sources v. Brooks*, 501 F. Supp. 334 (W.D. Pa. 1980); *Titsch Printing, Inc. v. Hastings*, 456 F. Supp. 445 (D. Colo. 1978). See also pre-*Kew* cases that apparently rejected the doctrine: *Occidental Life Ins. Co. v. Pat Ryan & Assocs., Inc.*, 496 F.2d 1255 (4th Cir.), *cert. denied*, 419 U.S. 1023 (1974); *Bronstein v. Bronstein*, 407 F. Supp. 925 (E.D. Pa. 1976). Also frequently cited as rejecting the doctrine, but arguably distinguishable, are *Glick v. Campagna*, 613 F.2d 31 (3d Cir. 1979), and *Coffin v. Polishing Machs., Inc.*, 596 F.2d 1202 (4th Cir. 1979).

22. 637 F.2d 1147 (7th Cir. 1981).

23. *Id.* at 1154.

24. 421 U.S. 837 (1975).

25. *Id.* at 847-58.

26. 637 F.2d 1147, 1152-53 (7th Cir. 1981).

27. 328 U.S. 293 (1946).

28. *Id.* at 301. The lower courts have tinkered with the third element of the *Howey* test. A prominent example is the Ninth Circuit's replacement of the solely-from-the-efforts-of-others requirement with a less

company as sole owner engages in no common enterprise, and because his total control means profits will come from his own efforts and not those of others, the *Poloway* court concluded that the *Howey* test was not met and that, therefore, no security was involved.<sup>29</sup>

The *Poloway* rationale had a persuasive effect. In the following year it was adopted by several district courts,<sup>30</sup> and in early 1982 the Eleventh Circuit joined the Seventh and Tenth Circuits by explicitly adopting a sale of business exception to the Securities Act coverage.<sup>31</sup> What appeared to be a road to near unanimous acceptance of the sale of business doctrine developed a large pothole, however, because of the first of two 1982 decisions, which focus and refine the issues in the sale of business doctrine debate. The Second Circuit's opinion in *Golden v. Garafalo*<sup>32</sup> was a ringing rejection of the doctrine. Although earlier opinions of the Third and Fourth Circuits had appeared to reject it,<sup>33</sup> *Garafalo* was the first clear assault on the doctrine at the circuit court level.

The second critical opinion came less than six months later when the Seventh Circuit responded to *Garafalo* by forcefully reaffirming its belief in the sale of business doctrine in *Sutter v. Groen*.<sup>34</sup> A brief examination of these two cases will lend perspective to the following detailed analysis of the sale of business doctrine arguments.

In *Garafalo* the plaintiffs purchased a ticket brokerage business from the defendant, intending to manage the business directly. The sale was structured as one of stock rather than of assets because of a nontransferable lease held in the name of the defendant's close corporation. The plaintiffs later sued under

stringent requirement that the efforts of others be the "undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." *SEC v. Glenn W. Turner Enters.*, 474 F.2d 476, 482 (9th Cir.), cert. denied, 414 U.S. 821 (1973).

29. 637 F.2d 1147, 1153 (7th Cir. 1981).

30. *Seagrave Corp. v. Vista Resources, Inc.*, 534 F. Supp. 378 (S.D.N.Y.), rev'd, 696 F.2d 227 (2d Cir. 1982); *Kane v. Fischbach*, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,608 (E.D.N.Y. 1982); *Reprosystem v. SCM Corp.*, 522 F. Supp. 1257 (S.D.N.Y. 1981); *Oakhill Cemetery v. Tri-State Bank*, 513 F. Supp. 885 (N.D. Ill. 1981); *Zilker v. Klein*, 510 F. Supp. 1070 (N.D. Ill. 1981); *Anchor-Darling Indus. v. Suozzo*, 510 F. Supp. 659 (E.D. Pa. 1981); *Barsy v. Verin*, 508 F. Supp. 952 (N.D. Ill. 1981).

31. *King v. Winkler*, 673 F.2d 342 (11th Cir. 1982); see also *Kaye v. Pawnee Constr. Co.*, 680 F.2d 1360 (11th Cir. 1982); *Canfield v. Rapp & Son, Inc.*, 654 F.2d 459 (7th Cir. 1981).

32. 678 F.2d 1139 (2d Cir. 1982). *Garafalo* has since been followed in *Seagrave Corp. v. Vista Resources, Inc.*, 696 F.2d 227 (2d Cir. 1982); *Sterling Recreational Org. v. Segal*, 537 F. Supp. 1024 (D. Colo. 1982); and *Stacey v. Charles J. Rogers, Inc.*, 542 F. Supp. 48 (E.D. Mich. 1982). As this Article went to press the Fifth Circuit also rejected the sale of business doctrine in *Daily v. Morgan*, [Current Binder] FED. SEC. L. REP. (CCH) ¶ 99,139 (5th Cir. 1983); see also *Cole v. Pittsburgh Plate Glass Indus. Inc.*, 680 F.2d 549 (8th Cir. 1982) (rejecting sale of business doctrine and applying Arkansas State law).

33. Three other circuit court holdings appear inconsistent with the sale of business doctrine. However, *Occidental Life Ins. Co. v. Pat Ryan & Assocs., Inc.*, 496 F.2d 1255 (4th Cir.), cert. denied, 419 U.S. 1023 (1974), predates the doctrine's true promulgation in *Chandler v. Kew, Inc.*, 691 F.2d 443 (10th Cir. 1977), so the Fourth Circuit did not have an opportunity to consider fully the arguments in favor of the sale of business doctrine. Also, that court's later decision in *Coffin v. Polishing Machs., Inc.*, 596 F.2d 1202 (4th Cir. 1979), is arguably consistent with the doctrine, though it is usually interpreted as rejecting it. Finally, the Third Circuit failed to explain its reasoning in *Glick v. Campagna*, 613 F.2d 31 (3d Cir. 1979).

34. 687 F.2d 197 (7th Cir. 1982). In *Sutter* the plaintiff bought 70% of the stock of Happy Radio, Inc., whose only significant asset was an agreement with defendants to buy all of their stock (100%) of Bret Broadcasting Corp. over a 12 year period, during which Happy had the right to manage Bret. The lawsuit arose upon the plaintiff's claim that the defendants had overstated Bret's earnings to gain an inflated purchase price.

section 17(a) of the '33 Act and section 10(b) of the '34 Act, claiming that the defendant had misrepresented the value of the business.<sup>35</sup>

The Second Circuit took a literalist (stock equals security) approach in reversing the trial court's dismissal, on the sale of business doctrine grounds, of plaintiffs' federal securities claims. Unlike the Seventh Circuit in *Poloway*, the court did not read *Forman* as establishing the economic reality approach, nor did it see the three-part *Howey* test as the exclusive determinant of the presence of a security.<sup>36</sup> Rather, the Second Circuit interpreted *Forman* to mean that if "real stock" is present, the securities laws apply and there is no need to resort to the *Howey* test.<sup>37</sup> Further, the court held that the *Howey* test applies only to the definition of an "investment contract," not to the definition of securities generally.<sup>38</sup> The *Garafalo* court also objected to the sale of business doctrine because the economic reality test was "slippery and elusive" and would require investigation of countless questions of mixed law and fact regarding whether the purchaser exercised passive or active control of the business.<sup>39</sup>

In *Sutter v. Groen* the Seventh Circuit vigorously defended the sale of business doctrine.<sup>40</sup> In a comprehensive opinion the court refuted point by point *Garafalo*'s literalist interpretation of *Forman* and the specific concerns about the "slipperiness" of the doctrine. The foundation of *Sutter*, the leading exposition of the sale of business doctrine, is the distinction between an "investor" and an "entrepreneur."<sup>41</sup> An investor is one who seeks to profit by entrusting his capital to others whose efforts will bring success.<sup>42</sup> An entrepreneur is one who seeks to profit primarily through his own efforts.<sup>43</sup> According to the *Sutter* court, the key question underlying the validity of the sale of business doctrine relates to whom Congress meant to protect when it passed the '33 and '34 Acts.<sup>44</sup> The court concluded that investors, not entrepreneurs, were the intended beneficiaries of the Securities Acts. Even though the purchaser bought corporate stock and was allegedly defrauded, no sale of a security within the meaning of the federal securities laws had occurred.<sup>45</sup>

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35. 678 F.2d 1139, 1140 (2d Cir. 1982).

36. *Id.* at 1143-44.

37. *Id.* at 1144.

38. *Id.* at 1145. *Howey* did not concern anything so obvious as corporate stock. Rather, the defendants were selling interests in a citrus grove, and the Supreme Court held that these interests constituted "investment contracts," a broad catch-all category listed in both the '33 and '34 Act definition of security. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 297-99 (1946).

39. 678 F.2d 1139, 1145-46 (2d Cir. 1982).

40. 687 F.2d 197 (7th Cir. 1982).

41. *Id.* at 201.

42. The "investors" who Congress was trying to protect by passage of the federal securities laws have been described as "all persons who have no special qualifications or opportunities for active participation in the direction of the enterprise, but, as individuals, merely contribute to the capital invested." Note, *Definition of "Security" within Meaning of Federal Statute—Investment Contracts*, 36 COLUM. L. REV. 683, 684 (1936).

43. BLACK'S LAW DICTIONARY 478 (5th ed. 1979).

44. 687 F.2d 197, 201 (7th Cir. 1982).

45. *Id.*

The issue has thus been joined. On the one hand, the Seventh, Tenth, and Eleventh Circuits apply the *Howey* test to every possible security question and hold that even corporate stock is not a security if its purchaser buys control and intends to take an active role in the business. On the other hand, the Second, Third, and Fourth Circuits hold that stock is a security, no matter how much is purchased or what the purchaser's intentions may be.

### B. Application of the Doctrine

The typical factual situation in a sale of business doctrine case is not difficult to sketch. First, the business being sold is owned by a relatively small corporation. Only one case applying the doctrine has concerned a sale for as much as twenty million dollars<sup>46</sup> and typically purchase prices are much lower.<sup>47</sup> Second, the purchased business is a close corporation with relatively few shareholders.<sup>48</sup> Third, the transaction concerns the purchase of a controlling interest in the corporation, usually 100 percent of the outstanding stock.<sup>49</sup> Fourth, the defendants are sellers of the stock and the plaintiffs are disgruntled purchasers who claim the stock is not worth as much as represented.<sup>50</sup> Fifth, the plaintiff purchased the controlling interest with the intent to manage or direct the management of the purchased corporation.<sup>51</sup>

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46. *Seagrave Corp. v. Vista Resources, Inc.*, 534 F. Supp. 378 (S.D.N.Y.), *rev'd*, 696 F.2d 227 (2d Cir. 1982).

47. *E.g.*, *King v. Winkler*, 673 F.2d 342 (11th Cir. 1982) (\$91,400); *Canfield v. Rapp & Son, Inc.*, 564 F.2d 459 (7th Cir. 1981) (\$2 million); *Frederiksen v. Poloway*, 637 F.2d 1147 (7th Cir. 1981) (\$191,800); *Reprosystem v. SCM Corp.*, 522 F. Supp. 1257 (S.D.N.Y. 1981) (\$10 million.).

48. Occasionally, the purchaser will be a public corporation, but the case closest to concerning a purchased public corporation is *Seagrave Corp. v. Vista Resources, Inc.*, 534 F. Supp. 378 (S.D.N.Y.), *rev'd*, 696 F.2d 227 (2d Cir. 1982). In that case Koffman wished to purchase "Old Seagrave," a public corporation. Because an agreement could not be reached on the price that would be paid for the stock in Old Seagrave, however, the transaction was structured so that Koffman would create and control "New Seagrave." New Seagrave would then purchase most of the assets of Old Seagrave and all of the stock it held in its 29 subsidiaries. The shareholders of Old Seagrave approved the transaction, and the court held that the sale of the stock of the subsidiaries was merely indicium of the transfer of ownership. *Id.* at 384.

49. In *Oakhill Cemetery v. Tri-State Bank*, 513 F. Supp. 885 (N.D. Ill. 1981), however, only 50% of the stock in the close corporation was purchased. Nonetheless, the court applied the sale of business doctrine because the purchaser in the transaction was to take management and control of the corporation. *Id.* at 890.

*Sutter v. Groen*, 687 F.2d. 197 (7th Cir. 1982), concerned two transactions. First, the plaintiff purchased a 70% interest in Happy Radio Inc., whose only significant asset was an agreement to buy 100% of Bret Broadcasting Corp. over a 12 year period, during which Happy had the right to manage. The court concluded that Happy's purchase of 100% of the stock was clearly covered by the sale of business doctrine and thus established a rebuttable presumption that the plaintiff's purchase of over 50% of Happy indicated an intent to purchase for control rather than for investment. *Id.* at 202-03.

50. A discussion of cases that do not fit this factual stereotype begins presently, *see infra* notes 52-81 and accompanying text.

51. A buyer has been designated an entrepreneur rather than an investor even though the entire management team of the purchased corporation was left intact by the purchase agreement. Though the purchaser was not involved in the day-to-day affairs of the corporation, his total ownership gave him the right to control. *Seagrave Corp. v. Vista Resources, Inc.*, 534 F. Supp. 378, 383-84 (S.D.N.Y.), *rev'd*, 696 F.2d 227 (2d Cir. 1982).

In *Kaiser v. Olson*, 105 Ill. App. 3d 1008, 435 N.E.2d 113 (1981), Olson was part of a group of purchasers of more than 50% of a corporation. Despite Olson's choice not to participate in the active management of the business, he was deemed not to be a "passive investor" protected by the securities laws because the "others" on whose efforts he relied were his own affiliates. *Id.* at 1013-14, 435 N.E.2d at 118; *see also* *Mr. Steak, Inc. v.*

Some sale of business doctrine cases, however, do not fit the "defrauded purchaser of 100-percent of small close corporation sues seller" model. These cases are worthy of discussion, because they present some of the more difficult legal problems associated with the doctrine.<sup>52</sup> One such case is *Coffin v. Polishing Machines, Inc.*,<sup>53</sup> in which the buyer, a distributor for Polishing Machines, Inc. (PMI), was convinced by PMI's president to purchase fifty percent of the company's outstanding stock and to become an executive vice president. The Fourth Circuit allowed the plaintiff to sue under federal securities law for fraud. Since the sale was made because "Polishing Machines wanted to sell stock in order to finance corporate expansion,"<sup>54</sup> the court held that a classic sale of securities for investment had occurred.<sup>55</sup> Despite the *Coffin* court's rejection of many of the legal arguments at the heart of the sale of business doctrine, some courts have tried to harmonize *Coffin* with the doctrine by concluding that because the purpose of the sale was to raise capital rather than to dispose of the business, the doctrine did not apply.<sup>56</sup>

*Glick v. Campagna*<sup>57</sup> concerned a seller suing a buyer, a reversal of the procedural position in most sale of business doctrine cases. Both parties were owners of fifty percent of the stock of Washington Marketing & Financial, Inc. (WMFI). Campagna allegedly defrauded Glick by purchasing Glick's half of the stock after painting an inaccurate, gloomy picture of the corporation's future.<sup>58</sup> When Glick found out how well the corporation was doing after he sold out, he sued under the securities laws. The Third Circuit rejected the contention that Glick and Campagna were actually partners and, therefore, the sale constituted nothing more than the sale of a partnership interest.<sup>59</sup> The court concluded that since WMFI had conducted its business as a corporation, the sale had involved a security.<sup>60</sup>

*Bronstein v. Bronstein*<sup>61</sup> presented a situation quite similar to that in

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River City Steak, Inc., 460 F.2d 666, 670 (10th Cir. 1972) (no security found when the investor delegated control to a third party over whom the investor had control, even though the investor ignored the daily operation of the business).

52. On the other hand, several cases flatly rejecting the doctrine do fit the classic factual mold described above. *E.g.*, *Golden v. Garafalo*, 678 F.2d 1139 (2d Cir. 1982); *Sterling Recreational Org. v. Segal*, 537 F. Supp. 1024 (D. Colo. 1982); *Mifflin Energy Sources v. Brooks*, 501 F. Supp. 334 (W.D. Pa. 1980); *Titsch Printing, Inc. v. Hastings*, 456 F. Supp. 445 (D. Colo. 1978).

53. 596 F.2d 1202 (4th Cir. 1979).

54. *Id.* at 1204.

55. *Id.*

56. *Frederiksen v. Poloway*, 637 F.2d 1147, 1151 (7th Cir. 1981); *Anchor-Darling Indus. v. Suozzo*, 510 F. Supp. 659, 665 (E.D. Pa. 1981).

57. 613 F.2d 31 (3d Cir. 1979).

58. *Id.* at 34-35.

59. *Id.* at 35.

60. *Id.* One could argue that *Glick* is not inconsistent with the sale of business doctrine because although Glick was on the board of directors of WMFI, he spent most of his time on other matters. Campagna was the president and true controlling influence of WMFI. Therefore, Glick might be characterized as an investor who had entrusted his capital to Campagna's efforts in hopes of a profit, rather than as an entrepreneur. If he was so characterized, even the sale of business doctrine might allow Glick to claim the protection of the securities laws, though this is not clear.

61. 407 F. Supp. 925 (E.D. Pa. 1976).



*Glick v. Campagna*. The plaintiff, holder of a one-third interest in Penn Tower, a Pennsylvania corporation engaged in real estate development, claimed that his brother, the defendant and also a one-third holder, defrauded him into selling his shares to the defendant at an inadequate price.<sup>62</sup> Because the plaintiff, the corporation's director and construction supervisor, relied on the defendant for all financial information, he could conceivably be characterized as an investor allowed to claim the protection of the federal securities laws. The *Bronstein* court's language, however, constitutes such a vigorous and direct assault on the basic logic underlying the sale of business doctrine<sup>63</sup> that it is unlikely that courts adopting the doctrine will attempt to reconcile *Bronstein* with their holdings.

*Stacey v. Charles J. Rogers, Inc.*<sup>64</sup> also concerned sellers suing the buyer. The buyer, plaintiff's brother-in-law, ran the interrelated family-held corporations that participated in the transaction. *Glick* and *Bronstein* were direct precedent for the district court's finding that a security was involved when all the plaintiff shareholders sold their shares to the corporation, leaving the defendant as the sole shareholder.<sup>65</sup>

The Seventh Circuit—the leading exponent of the sale of business doctrine—was presented with a similar factual situation in *McGrath v. Zenith Radio Corp.*<sup>66</sup> Plaintiff McGrath, a vice-president of Basford Company, held an option to buy a large number of its shares. McGrath had been hired with the understanding that he would eventually become Basford's president. Basford was a distributor of Zenith products. When Zenith Corporation started to negotiate for the purchase of Basford, McGrath negotiated on Basford's behalf, trying to protect Basford's employees and to get a fair price for its shareholders.<sup>67</sup> Because Zenith desired to acquire 100 percent of the Basford stock, McGrath agreed to waive his stock option as long as both parties understood he was still to be president of the new company and to retain a substantial stock option in Zenith. Shortly after McGrath's proposal Zenith decided that McGrath would not be a suitable president for the new company; it did not inform him of its decision. Subsequently, McGrath and all other Basford shareholders sold their shares to Zenith, and shortly thereafter McGrath was fired.<sup>68</sup>

When McGrath sued under the federal securities laws, the Seventh Circuit distinguished *Poloway* on the basis of the investor-entrepreneur dichotomy.<sup>69</sup> The court stressed that the plaintiff and the other Basford shareholders were investors and that they did not lose that status simply because all

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62. *Id.* at 926.

63. *Id.* at 927-30.

64. 542 F. Supp. 48 (E.D. Mich. 1982).

65. *Id.* at 50.

66. 651 F.2d 458 (7th Cir. 1981).

67. *Id.* at 462.

68. *Id.*

69. *Id.* at 467 n.5.

their shares were purchased at one time by a buyer who meant to take control.<sup>70</sup> In short, the court stated that although a buyer of control is not an investor and, therefore, not protected by the securities laws, the sellers from whom he purchased may be investors entitled to protection.<sup>71</sup> Although unstated, this means the Seventh Circuit held that the stock certificates that McGrath sold to Zenith were securities to McGrath, but not to Zenith.

*Barsy v. Verin*<sup>72</sup> is another case in which the sale of business doctrine was applied in a nontypical situation. Both Barsy and Verin were sellers. Barsy owned fifty percent of the stock in a close corporation; Verin owned forty-two percent. The remaining eight percent was held by their former attorney's widow. All three shareholders sold their stock to Monarch, who became the sole owner. Barsy sued Verin, claiming that Verin had received a secret premium for his stock.<sup>73</sup> Verin counterclaimed on similar grounds. The court held *Poloway* controlling; since Monarch bought control and could not sue Barsy and Verin under the sale of business doctrine, they in turn should be precluded from suing each other.<sup>74</sup> Unlike *McGrath* the *Barsy* court assumed that if the stock purchased was not a security to Monarch, it could not be a security to any other party to the transaction.

Seldin, a commentator who embraces the sale of business doctrine, has endorsed *Barsy's* result; since Barsy and Verin were both owners of substantial shares and, therefore, arguably entrepreneurs rather than mere investors, neither deserved protection under the securities laws.<sup>75</sup> Seldin, however, views the rationale as incorrect; despite Monarch's inability to sue either Barsy or Verin, Seldin argues that the eight percent seller, clearly an investor, should be protected under the securities laws.<sup>76</sup>

Also of interest is *Zilker v. Klein*,<sup>77</sup> a derivative action brought on behalf of Bally Manufacturing Corporation. Bally had purchased 100 percent of the stock of one of its distributors, owned by Bally's president and two others. Because Bally had purchased all the distributor's stock and had taken control of the corporation, the court held *Poloway* to be determinative.<sup>78</sup> The sale of stock was held to be merely incidental to the transfer of control of the business,<sup>79</sup> and Bally was not allowed to recover the 9.5 million dollars it had paid for the distributor's stock.

In the court's opinion Bally's status as a publicly-held corporation was inconsequential.<sup>80</sup> The court noted that application of the sale of business

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70. *Id.* at 468 n.5.

71. *Id.*

72. 508 F. Supp. 952 (N.D. Ill. 1981).

73. *Id.* at 956.

74. *Id.* at 958.

75. See Seldin I, *supra* note 10, at 650.

76. *Id.*

77. 510 F. Supp. 1070 (N.D. Ill. 1981).

78. *Id.* at 1075.

79. *Id.*

80. *Id.*

doctrine was not "dependent on the size or nature of the acquired enterprise. Instead, the decision was based on the *purpose* of the purchase: business acquisition v. investment securities acquisition."<sup>81</sup>

The distinction between a business acquisition and an investment securities acquisition appears to be the key to the sale of business doctrine's application to various factual situations. Under the doctrine an investor who buys or sells corporate stock is buying a security. An entrepreneur who buys or sells corporate stock is not buying a security. Thus, if an entrepreneur buys stock from an investor, for example, if Monarch buys part of its 100 percent from an 8 percent holder, the stock is not a security to Monarch, but is a security to the investor-seller, the 8 percent holder.

Seldin has produced a chart summarizing what he believes to be the proper application of the sale of business doctrine in different factual situations.<sup>82</sup>

Plaintiff	Defendant	Doctrine Applicable?
(1) Purchaser	Dominant Active Seller	Yes
(2) Purchaser	Minority Passive Seller	Yes
(3) Dominant Active Seller	Purchaser	Yes
(4) Minority Passive Seller	Purchaser	No
(5) Minority Passive Seller	Dominant Active Seller	No

Whether a party is a minority passive seller (an investor) or is buying or selling control (an entrepreneur) is a question of fact. The *Sutter* court attempted to facilitate the fact-finding process by establishing a rebuttable presumption that a purchaser of more than fifty percent of a corporation's stock is seeking control, while a purchaser of less than fifty percent is buying for an investment.<sup>83</sup>

### III. EVALUATING THE SALE OF BUSINESS DOCTRINE

Courts adopting the sale of business doctrine hold that corporate stock is not a security when a controlling block is bought or sold.<sup>84</sup> To establish the validity of the sale of business doctrine, these courts and other advocates must accomplish three objectives: first, they must convincingly show that the definitions of security in the securities laws are not to be taken literally; that is, just because "stock" is listed in the statutory definitions does not mean that it is always and under all circumstances a security.<sup>85</sup> Second, proponents

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81. *Id.*

82. See Seldin II, *supra* note 10, at 35.

83. 687 F.2d 197, 203 (7th Cir. 1982).

84. At least it is not a security for the person buying or selling control. See *supra* note 82 and accompanying text.

85. See *infra* notes 88-180 and accompanying text.

must establish the legitimacy of a definitional standard under which the presence of a security turns on whether the plaintiff is an investor or an entrepreneur.<sup>86</sup> Third, they must establish that the remedial goals of the securities laws are advanced by adoption of this imaginative new rule.<sup>87</sup>

This section demonstrates, by an analysis of the major sale of business doctrine cases and arguments, that proponents of the doctrine have failed to achieve any of the three goals.

A. *Should the '33 and '34 Act Definitions Be Taken Literally?*

1. *Conflict with Statutory Language and Policy*

Initially, the sale of business doctrine is grounded upon removal of ordinary common stock from the statutory definition of security. Neither the history nor the language of the securities laws supports this interpretation.<sup>88</sup> Congress chose to define the term "security" by listing examples.<sup>89</sup> One of the examples listed in both the '33 and '34 Acts is "stock."

The statutes' wording clearly indicates that corporate stock is a security. Although transactional analysis may be appropriate to determine whether a particular instrument falls within one of the categories listed by Congress,<sup>90</sup> its use to determine whether corporate stock is a security both ignores the statutory language and renders meaningless the explicit congressional listing of included instruments. As the Second Circuit noted in *Garafalo*:

If an "economic reality" test were intended, reference to such specific types of instruments, and common variations of them, would have been inappropriate because a substantial portion of each class of instrument would, in fact, not be within the definition. We believe that Congress intended to draft an expansive definition and to include with specificity all instruments with characteristics agreed upon in the commercial world, such as "debentures," "stock," "treasury stock" or "voting-trust certificates." Catch-all phrases such as "investment contract," were then included to cover unique instruments not easily classified. If the "economic reality" test were to be the core of the definition, only general catch-all terms would have been used.<sup>91</sup>

Instead of being ignored, Congress' words should be given an expansive reading. The securities laws are broadly remedial in nature and should be liberally interpreted to achieve their purposes.<sup>92</sup> This expansive approach is

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86. See *infra* notes 181-213 and accompanying text.

87. See *infra* notes 214-97 and accompanying text.

88. See *supra* note 4.

89. Note, *Purchase of Stock*, *supra* note 12, at 1251 n.191.

90. The Supreme Court used the three-part *Howey* test in *Forman* to determine whether instruments that were denominated "stock," but actually were not, could be classified as "investment contracts" and, therefore, securities. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 851-53 (1975).

91. *Golden v. Garafalo*, 678 F.2d 1139, 1144 (2d Cir. 1982).

92. *Marine Bank v. Weaver*, 455 U.S. 551, 555-56 (1982); *Tcherepnin v. Knight*, 389 U.S. 332, 339 (1967); *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 353 (1943); *Occidental Life Ins. Co. v. Pat Ryan & Assocs., Inc.*, 496 F.2d 1255, 1262 (4th Cir.), *cert. denied*, 419 U.S. 1023 (1974); *Alberto-Culver Co. v. Scherk*, 484 F.2d 611, 615 (7th Cir. 1973), *rev'd on other grounds*, 417 U.S. 506 (1974); *Mifflin Energy Sources v. Brooks*, 501 F. Supp. 334, 336 (W.D. Pa. 1980); *Titsch Printing, Inc. v. Hastings*, 456 F. Supp. 445, 449 (D. Colo. 1978); *Bronstein v. Bronstein*, 407 F. Supp. 925, 929 (E.D. Pa. 1976).

particularly appropriate for the definition of a security. Congress' listing approach was inclusive in nature, representing an attempt to extend federal securities law coverage not only to the traditional securities such as common stock, but also to the unique devices that promoters had used to evade earlier blue sky laws.<sup>93</sup>

Although federal securities laws are to be liberally construed, given their remedial nature, every question regarding the existence of a security need not be decided in favor of inclusiveness.<sup>94</sup> Nonetheless, sale of business doctrine proponents cannot point to any specific language in the legislative history of the '33 and '34 Acts to support the proposition that ordinary corporate common stock should be excluded from the laws' protection. On the contrary, House Report No. 85, accompanying the '33 Act, states that it defines "the term 'security' in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security."<sup>95</sup>

If any existing instrument falls within the "ordinary concept of a security," it is corporate common stock. Referring to the House Report, the Second Circuit noted in *Garafalo*:

We regard this statement as support for the proposition that instruments ordinarily regarded as "stock" are a "security," notwithstanding that the underlying transaction involves a transfer of control. This understanding of Congressional intent, moreover, has been almost universally accepted by the courts, the relevant agency and the bar for over 40 years. Only after *Forman* has there been a serious challenge to this reading of the statutes.<sup>96</sup>

Courts adopting the sale of business doctrine have mustered several arguments that purportedly overcome the plain wording of the '33 and '34 Act definitions of security. This Article will examine each of these arguments.

## 2. "Unless the Context Otherwise Requires"

Cases recognizing the sale of business doctrine place particular emphasis on the language "unless the context otherwise requires," which precedes the statutory definition of security in both the '33 and '34 Acts.<sup>97</sup> This language is commonly cited as justifying consideration of the economic context of a transaction in order to remove the stock from the classification of security.<sup>98</sup>

Conspicuous by its absence in such an analysis is the language preceding the clause quoted above. Stated in full, the following language introduces the

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93. Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 183 (1933); Note, *Legislation—Uniform Sale of Securities Act*, 30 COLUM. L. REV. 1189, 1191 (1930).

94. *Condux v. Neldon*, 83 Ill. App. 3d 575, 584-85, 404 N.E.2d 523, 530 (1980).

95. *Tcherepnin v. Knight*, 389 U.S. 332, 338 n.19 (quoting H.R. REP. NO. 85, 73d Cong., 1st Sess. 11 (1933)).

96. 678 F.2d 1139, 1144-45 (2d Cir. 1982).

97. See, e.g., § 2 of the '33 Act, 15 U.S.C. § 77b(1) (Supp. V 1981), and § 3 of the '34 Act, 15 U.S.C. § 78c(a) (Supp. V 1981).

98. *Frederiksen v. Poloway*, 637 F.2d 1147, 1150 (7th Cir. 1981); *Seagrave Corp. v. Vista Resources, Inc.*, 534 F. Supp. 378, 381 (S.D.N.Y.), *rev'd*, 696 F.2d 227 (2d Cir. 1982); *Reprosystem v. SCM Corp.*, 522 F. Supp. 1257, 1274 (S.D.N.Y. 1981); *Golden v. Garafalo*, 521 F. Supp. 350, 358 (S.D.N.Y. 1981), *rev'd*, 678 F.2d 1139 (2d Cir. 1982).

fifteen definitional sections of the '33 Act: "When used in this title, unless the context otherwise requires—."<sup>99</sup> Similar language precedes the forty definitional sections of the '34 Act.<sup>100</sup>

A plain reading of these clauses leads inexorably to the conclusion that the "context" referred to is the linguistic context in which the defined term is used in the subsequent provisions.<sup>101</sup> Indeed, "economic reality" does not determine the definitions of terms like "person," "director," "bank," or "State," all of which are preceded by the "context" language.<sup>102</sup> Thus, no reason exists to adopt a contrary approach for the definition of "stock," particularly since the security definition is obviously drafted to be all-inclusive. The litany of instruments recited is intended to encompass all securities, not only those in traditional form, to avoid circumvention of the broad remedial provisions of the securities laws.

Professor James, writing in 1934, noted that the position that "context" refers to the linguistic context of the statute and not the economic context of the underlying transaction finds support from the derivation of the definition of security in the '33 Act: it "was lifted almost bodily from the proposed Uniform Sale of Securities Act adopted by the National Conference of Commissioners on Uniform State Laws in October, 1929."<sup>103</sup> Section one of that Act states: "When used in this act the following terms shall, unless the text otherwise indicates, have the following respective meanings . . . ."<sup>104</sup> Although the slight wording change made by Congress might indicate an intent to change the meaning,<sup>105</sup> it is more reasonable to assume that, in drafting the Acts, Congress used "context" to refer to the linguistic context of the statute. Had Congress intended to change the meaning of the phrase, certainly it would have made a more significant alteration in wording to make that intent clear.

A similar conclusion may be drawn regarding the '34 Act's definition that, to the extent its language substantially tracks that in the '33 Act, was also derived from the Uniform Sale of Securities Act. Additionally, attorney Harold Hammett has noted:

In 1934, when Congress wrote that preface to section 3, section 1 of the Revised Statutes stated in pertinent part, "In determining the meaning of any Act

99. See, e.g., § 2 of the '33 Act, 15 U.S.C. § 77b(1) (Supp. V 1981) (emphasis added).

100. See, e.g., § 3 of the '34 Act, 15 U.S.C. § 78c(a) (Supp. V 1981).

101. See 4 L. LOSS, SECURITIES REGULATION 2485 (Supp. 1969); Dillport, *Restoring Balance to the Definition of Security*, 10 SEC. REG. L.J. 99, 109 n.35 (1982) [hereinafter cited as Dillport, *Restoring Balance*]; Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 HASTINGS L.J. 219, 278-79 (1974); Sonnenschein, *Federal Securities Law Coverage of Note Transactions: The Antifraud Provisions*, 35 BUS. LAW. 1567, 1576-77 (1980).

102. See § 3(a)(9), (7), (6), and (16) of the '34 Act, 15 U.S.C. § 78c(a)(9), (7), (6), and (16) (Supp. V 1981).

103. James, *The Securities Act of 1933*, 32 MICH. L. REV. 624, 631 (1934).

104. HANDBOOK OF THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS AND PROCEEDINGS OF THE THIRTY-NINTH ANNUAL CONFERENCE 173 (1929) (emphasis added).

105. Thompson, *The Shrinking Definition of a Security: Why Purchasing All of a Company's Stock is not a Federal Security Transaction*, 57 N.Y.U. L. REV. 225, 250 n.145 (1982).

or resolution of Congress, words importing the singular number may extend and be applied to several persons or things, . . . unless the context shows that such words were intended to be used in a more limited sense . . . ." This language was carried forward into the very first section of the United States Code. The result is a Congressionally mandated rule of construction that begins with the words "[i]n determining the meaning of any Act of Congress, unless the context indicates otherwise . . . ."

These instructions can only indicate that the meaning of a defined term is first determined in the context of the Congressional statute itself. After its meaning is so determined, the term is *applied to*, *not defined by*, the conduct or transaction to which it allegedly is pertinent.<sup>106</sup>

In *SEC v. National Securities, Inc.*<sup>107</sup> the Supreme Court explicitly endorsed the view that the "context" referred to in these Acts is the linguistic rather than the transactional context:

Although the interdependence of the various sections of the securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen, ordinary rules of statutory construction still apply. The meaning of particular phrases must be determined in context. . . . *Congress itself has cautioned that the same words may take on a different coloration in different sections of the securities laws*; both the 1933 and the 1934 Acts preface their lists of general definitions with the phrase "unless the context otherwise requires." . . . We must therefore address ourselves to the meaning of the words "purchase or sale" in the context of § 10(b).<sup>108</sup>

Thus, the legislative history of the Acts as well as their interpretation by the Supreme Court clearly support Hammett's conclusion that

[r]esort to the context of the transaction, instead of the context of the statute, while reaching a widely-approved result, is unfounded. The "context" referred to in the prefatory clause to section 3 of the 1934 Act is the context of the statute itself. Congress attempted to define critical terms in the statute; it did not delegate its definition-making authority to litigants. The clause is merely a warning that a defined term may mean one thing in one section of the Act and another thing in a different section. The use of this or similar language is not unusual or unique.<sup>109</sup>

### 3. Forman *Eliminated the "Literalist" Approach*

Most courts adopting the sale of business doctrine rely upon *United Housing Foundation, Inc. v. Forman*<sup>110</sup> to bolster their conclusion that a

106. Hammett, *Any Promissory Note: The Obscene Security—A Search for the Non-Commercial Investment*, 7 TEX. TECH L. REV. 25, 39–40 (1975) (emphasis in original).

107. 393 U.S. 453 (1969).

108. *Id.* at 466 (emphasis added).

109. Hammett, *Any Promissory Note: The Obscene Security—A Search for the Non-Commercial Investment* 1139 (2d Cir. 1982); *Dueker v. Turner*, [1979–1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶97,386, at 97,536 (N.D. Ga. 1979); see also *Somogyi v. Butler*, 518 F. Supp. 970, 984 (D.N.J. 1981); *Ellis v. Henderson*, [1980

110. 421 U.S. 837 (1975).

literalist approach should not be taken in defining a security.<sup>111</sup> In *Forman* an instrument labeled "stock" was held not to constitute a security.<sup>112</sup>

Admittedly, *Forman's* meaning is not crystal clear. Commentators have suggested that conflicting interpretations of *Forman* are essentially "quotation contests"<sup>113</sup> and that "[f]uture battles over the application of the sale of business doctrine are more likely to be fought on the facts of each case and the policy arguments for and against the doctrine"<sup>114</sup> than upon which interpretation of *Forman* ultimately prevails. Although *Forman* may not be decisive, it is nevertheless consistent with rejection of the sale of business doctrine.

Courts relying on *Forman* as support for the sale of business doctrine are plagued by the absence in *Forman* of either stock or the sale of a business. In *Forman*, unlike the sale of business cases, the Court struggled to characterize a unique instrument called stock but possessing none of the essential attributes of ordinary corporate stock.<sup>115</sup> Because sale of business cases concern garden-variety common stock, even the Seventh Circuit in *Sutter* admitted that *Forman* provided shaky precedent for recognition of a sale of business exception.<sup>116</sup>

Since *Forman* is factually distinguishable, it provides no direct support for the sale of business doctrine. On a more general level, however, *Forman* quotes *Church of the Holy Trinity v. United States*<sup>117</sup> for the proposition that "a thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers."<sup>118</sup> This long standing rule of statutory construction is cited by several courts adopting the sale of business rule as support for holding that "stock," even though listed in the '33 and '34 Acts' definitional sections, need not always be a security.<sup>119</sup>

Unfortunately for those courts, however, *Holy Trinity* authorizes rejection of explicit statutory language only if its literal application would "lead to

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111. *Frederiksen v. Poloway*, 637 F.2d 1147, 1150 (7th Cir. 1981); *Reprosystem v. SCM Corp.*, 522 F. Supp. 1257, 1274 (S.D.N.Y. 1981); *Golden v. Garafalo*, 521 F. Supp. 350, 353 (S.D.N.Y. 1981), *rev'd*, 678 F.2d 1139 (2d Cir. 1982); *Dueker v. Turner*, [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,386, at 97,536 (N.D. Ga. 1979); *see also Somogyi v. Butler*, 518 F. Supp. 970, 984 (D.N.J. 1981), *Ellis v. Henderson*, [1980 Transfer Binder] FED. SEC. L. REP. ¶ 97,722, at 98,785 (W.D. Okla. 1980).

112. In rejecting a literalist approach, the *Forman* court overruled an earlier statement in *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943), that "[i]nstruments may be included within any of these definitions, as matter of law, if on their face they answer to the name or description." 421 U.S. 837, 850 (1975).

113. *See Seldin I*, *supra* note 10, at 665.

114. *Id.* at 669.

115. 421 U.S. 837, 851 (1975).

116. 687 F.2d 197, 200 (7th Cir. 1982). Cases distinguishing *Forman* on this ground and, consequently, rejecting the sale of business doctrine include *Coffin v. Polishing Machs., Inc.*, 596 F.2d 1202, 1204 (4th Cir. 1979); *Mifflin Energy Sources v. Brooks*, 501 F. Supp. 334, 335-36 (W.D. Pa. 1980); and *Bronstein v. Bronstein*, 407 F. Supp. 925, 929-30 (E.D. Pa. 1976).

117. 143 U.S. 457 (1892).

118. *Id.* at 459, *quoted in* 421 U.S. 837, 849 (1975).

119. *King v. Winkler*, 673 F.2d 342, 346 (11th Cir. 1982); *Frederiksen v. Poloway*, 637 F.2d 1147, 1150 (7th Cir. 1981); *Condux v. Neldon*, 83 Ill. App. 3d 575, 584-85, 404 N.E.2d 523, 530 (1980).



injustice, oppression or an *absurd consequence*.'"<sup>120</sup> It might be absurd to label an instrument that is no more than a receipt for a refundable deposit on an apartment a security; it is extremely difficult, however, to imagine a situation in which it would be absurd to hold that garden-variety common stock is a security, since in a sale of business situation the common stock that changes hands has the characteristics that the *Forman* Court said signify the presence of stock; for example, the right to receive dividends contingent upon an apportionment of profits, negotiability, voting rights, and the chance of appreciation in value.<sup>121</sup>

Moreover, at the risk of perpetuating the "quotation contest" generated by *Forman*, the following language from the opinion further undermines a basic rationale of the sale of business doctrine:

In holding that the name given to an instrument is not dispositive, we do not suggest that the name is wholly irrelevant to the decision whether it is a security. There may be occasions when the use of a traditional name such as "stocks" or "bonds" will lead a purchaser justifiably to assume that the federal securities laws apply. This would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument.<sup>122</sup>

Thus, use of the label "stock" leads to a presumption that the securities laws apply.<sup>123</sup> Proponents of the sale of business doctrine ignore this critical consideration—that parties might reasonably expect the securities laws to apply if their interest is labeled a security.<sup>124</sup> The plaintiffs in *Forman* could not have reasonably believed that the instruments they were acquiring were

120. 143 U.S. 457, 461 (1892) (quoting *United States v. Kirby*, 74 U.S. (7 Wall.) 482, 486 (1868)) (emphasis added).

121. 421 U.S. 837, 851 (1975).

122. *Id.* at 850–51.

123. *Tcherepnin v. Knight*, 389 U.S. 332, 339 (1967); *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943); *Coffin v. Polishing Machs., Inc.*, 596 F.2d 1202, 1204 (4th Cir. 1979); *Occidental Life Ins. Co. v. Pat Ryan & Assocs., Inc.*, 496 F.2d 1255, 1261 (4th Cir.), *cert. denied*, 419 U.S. 1023 (1974); *Mifflin Energy Sources v. Brooks*, 501 F. Supp. 334, 336 (W.D. Pa. 1980); *see also* Dillport, *Restoring Balance*, *supra* note 101, at 115; Comment, *Securities Regulation—Is Stock a Security?*, 30 U. KAN. L. REV. 117, 121 (1981) [hereinafter cited as Comment, *Securities Regulation*].

124. Cases that have considered *Forman's* discussion of the reasonable expectation of the parties to be critical to their rejection of the sale of business doctrine include *Mifflin Energy Sources v. Brooks*, 501 F. Supp. 334, 336 (W.D. Pa. 1980); *Titsch Printing, Inc. v. Hastings*, 456 F. Supp. 445, 448–49 (D. Colo. 1978); *Bronstein v. Bronstein*, 407 F. Supp. 925, 929 (E.D. Pa. 1976); *see also* *Alna Capital Assocs. v. Wagner*, 532 F. Supp. 591, 602 (S.D. Fla. 1982).

In language generally applicable to most sale of business doctrine cases, the *Bronstein* court carefully explained just how reasonable an expectation of securities law coverage is in such transactions:

No party contends that Penn Tower is not a duly incorporated and validly existing Pennsylvania corporation. Furthermore, the Penn Tower shares, possessing as they do many features codified under Pennsylvania State law as characteristic of stock shares, would lead the reasonable investor to believe that the shares he had bought were indeed stock. For example, the shares are represented by a certificate, 15 P.S. § 1607; they're transferable in accordance with corporate by-laws, 15 P.S. § 1613; they entitle the holder to voting rights, 15 P.S. § 1504; and dividends, 15 P.S. § 1702. Quite obviously, then, the Penn Tower shares are formally indistinguishable from traditional shares of stock.

407 F. Supp. 925, 928–29 (E.D. Pa. 1976).

investment securities merely because they were called shares of stock.<sup>125</sup> The situation, however, is quite different in the sale of business case. The instruments changing hands not only are labeled "stock," but also have all the "significant characteristics typically associated with" stock,<sup>126</sup> and certainly fall within the ordinary concept of a security. For all these reasons, parties to the sale of a business reasonably and justifiably may expect that the securities laws will cover their transaction.

Furthermore, one may argue that the motivation for structuring a transaction as a sale of stock rather than as a sale of assets or in some other form may well be to take advantage of the substantial protection from fraud afforded buyers and sellers of stock by the federal securities laws, most notably rule 10b-5 of the '34 Act. Although it may be true that considerations other than securities law protection may motivate the parties to characterize the transaction as a sale of stock,<sup>127</sup> this does not support denial of federal protection that traditionally is not dependent upon reliance.<sup>128</sup> In any event, courts

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125. 421 U.S. 837, 851 (1975).

126. Although Seldin argues that this language supports the sale of business doctrine because it is preceded by the phrase "when the underlying transaction embodies" the significant characteristics associated with stock, Seldin I, *supra* note 10, at 668 (emphasis added), clearly if an instrument is both labeled "stock" and (unlike in *Forman*) has the characteristics of stock, nothing in *Forman* hints that the instrument should not be treated as a security.

Champions of "contexting" might be advised to place the quoted language in the "context" of the *Forman* opinion when interpreting its meaning. Not only did the instrument labeled "stock" in *Forman* have none of the basic attributes of corporate stock, but the underlying transaction was in essence a security deposit on a residential apartment. Therefore, in *Forman* neither the instrument nor the underlying transaction had even the slightest connection to an ordinary security transaction. The securities laws were not passed to regulate residential security deposits. On the other hand, in the sale of business case the instrument has all the characteristics of ordinary corporate stock (because it is corporate stock) and the underlying transaction is the sale of a business through the transfer of that stock. The issue in sale of business cases is fraud in connection with the stock transfer arising from misrepresentations concerning the value of the business. It strains both statutory language and policy to assert that such a transaction is outside the securities laws. On the contrary, fraud in connection with the sale of corporate stock is precisely the evil the securities laws were enacted to remedy.

127. Seldin suggests other reasons for structuring a sale as a transaction in stock, such as tax considerations, relief from liabilities, and avoidance of complications traditionally involved in a sale of assets. Seldin I, *supra* note 10, at 637. A nonassignable lease was the underlying reason for framing the transaction as a sale of stock in *Golden v. Garafalo*, 678 F.2d 1139, 1140 (2d Cir. 1982).

To be more specific about the tax aspect, from the seller's perspective two of the major benefits of structuring the agreement as a stock transfer are the avoidance of tax recapture provisions and the flow-through of the selling corporation's accumulated tax preference benefits. Comment, *The Sale of a Close Corporation*, *supra* note 12, at 762-63. From the purchaser's perspective, a sale of assets would probably be more desirable, since under the agreement he would largely control which assets and liabilities he would acquire and thus would avoid the acquisition of the unknown liabilities inherent in a purchase of stock agreement. J. MCGAFFEY, *BUYING, SELLING & MERGING BUSINESSES* 1-3 (1979); W. PAINTER, *CORPORATE AND TAX ASPECTS OF CLOSELY HELD CORPORATIONS* §§ 8.2-8.4 (2d ed. 1981). Under prior tax laws, stock purchases were frequently used to acquire assets because they could be followed by immediate liquidation of the acquired corporation for tax purposes. See generally Note, *Corporate Liquidations Incident to the Acquisition of Assets: A Look at Some Current Problems Arising From a Section 332-334(b)(2) Liquidation*, 27 U. FLA. L. REV. 390 (1975). Enactment of TEFRA in 1982 may have altered the situation, because § 337 of the I.R.C. now offers additional grounds for treating a stock purchase and liquidation as a direct purchase of assets for tax purposes. See generally THE RIA COMPLETE ANALYSIS OF THE 1982 TAX EQUITY AND FISCAL RESPONSIBILITY ACT (1982); Diller, *Corporate Liquidations and the Tax Benefit Rules: A Search for the Recovery Element*, 9 OHIO N.U.L. REV. 257 (1982).

128. Comment, *The Sale of a Close Corporation*, *supra* note 12, at 763. In one case favoring the sale of business doctrine, the trial court took an opposite view, blithely concluding that "the expectations, subjective

should not ignore the means chosen by the parties to effect their transaction. As noted in *Coffin v. Polishing Machines, Inc.*:

When ordinary corporate stock is involved in a transaction, we likewise need not consider whether the parties could have structured their arrangement in some other form. The parties in this case chose to implement their plan for joint ownership by means of a stock transfer rather than a partnership agreement or a sale of assets. Having decided to deal in stock, they brought their transaction under the provisions of the federal securities laws.<sup>129</sup>

#### 4. *Marine Bank v. Weaver Altered the "Literalist" Approach*

Implicit recognition that *Forman* is easily distinguishable led the Seventh Circuit in *Sutter* to shift its reliance from *Forman* to the Supreme Court's most recent decision defining a security, *Marine Bank v. Weaver*,<sup>130</sup> to obtain "solid support"<sup>131</sup> for the sale of business doctrine. *Sutter* claims that *Weaver* provides definitive justification for eliminating the "literalist" approach to defining securities in sale of business cases. An analysis of *Weaver*, however, demonstrates that it provides no better support for the sale of business doctrine than does *Forman*.

The case arose from the Weavers' purchase of a 50,000 dollar, six-year certificate of deposit from the Marine Bank.<sup>132</sup> The Weavers subsequently pledged the certificate back to the bank to guarantee a 65,000 dollar loan from the bank to the Columbus Packing Company. At the time Columbus owed the bank 33,000 dollars and was also substantially overdrawn on its checking account. Columbus subsequently went bankrupt, and the suit arose out of the Weavers' allegation that the bank had misrepresented the use to which the 65,000 dollars would be put and had failed to disclose Columbus' precarious financial condition.<sup>133</sup> According to the Weavers, the bank represented that the pledged funds would be used for working capital when they were actually used to pay off Columbus' indebtedness to the bank. The Weavers' suit alleged common-law fraud as well as a violation of rule 10b-5.<sup>134</sup> The rule 10b-5 claim was predicated, in part, on the plaintiffs' assertion that the certificate of deposit was a security within the statutory definition of the '34 Act.<sup>135</sup>

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intentions and motivations of parties do not determine whether the federal securities laws apply," notwithstanding evidence that the representation and warranties relied upon were those in the defendant's 10-K and 10-Q Reports filed with the SEC. *Seagrave Corp. v. Vista Resources, Inc.*, 534 F. Supp. 378, 383 (S.D.N.Y.), *rev'd*, 696 F.2d 227 (2d Cir. 1982).

129. 596 F.2d 1202, 1204 (4th Cir. 1979); *see also* *Occidental Life Ins. Co. v. Pat Ryan & Assocs., Inc.*, 496 F.2d 1255, 1262 (4th Cir.), *cert. denied*, 419 U.S. 1023 (1974); *Bailey v. Meister Brau, Inc.*, 320 F. Supp. 539, 543 (N.D. Ill. 1970).

130. 455 U.S. 551 (1982).

131. 687 F.2d 197, 200 (7th Cir. 1982).

132. 455 U.S. 551, 552 (1982).

133. *Id.* at 554.

134. *Id.*

135. The Court also had to consider whether the "separate agreement" between the Weavers and the owners of Columbus Packing was a security. *Id.* at 559-60.

The Third Circuit found the certificate of deposit to be a security,<sup>136</sup> but the Supreme Court reversed, stating in part:

This certificate of deposit was issued by a federally regulated bank which is subject to the comprehensive set of regulations governing the banking industry. Deposits in federally regulated banks are protected by the reserve, reporting, and inspection requirements of the federal banking laws; advertising relating to the interest paid on deposits is also regulated. In addition, deposits are insured by the Federal Deposit Insurance Corporation. Since its formation in 1933, nearly all depositors in failing banks insured by the FDIC have received payment in full, even payment for the portions of their deposits above the amounts insured. *1980 Annual Report of the Federal Deposit Insurance Corporation* 18-21 (1981).

We see, therefore, important differences between a certificate of deposit purchased from a federally regulated bank and other long-term debt obligations. The Court of Appeals failed to give appropriate weight to the important fact that the purchaser of a certificate of deposit is virtually guaranteed payment in full, whereas the holder of an ordinary long-term debt obligation assumes the risk of the borrower's insolvency. The definition of "security" in the 1934 Act provides that an instrument which seems to fall within the broad sweep of the Act is not to be considered a security if the context otherwise requires. It is unnecessary to subject issuers of bank certificates of deposit to liability under the anti-fraud provisions of the federal securities laws *since the holders of bank certificates of deposit are abundantly protected under the federal banking laws*. We therefore hold that the certificate of deposit purchased by the Weavers is not a security.<sup>137</sup>

*Sutter's* reliance on *Weaver* is misplaced. First, at the most obvious level, *Weaver*, like *Forman*, concerned neither stock nor the sale of a business. Any support for the sale of business doctrine must be made by analogy to the transfer of different instruments in factual situations having nothing to do with the transfer of a business.

Second, in another portion of the opinion the Supreme Court explicitly noted that the statutory definition of security in the '34 Act "includes ordinary stocks."<sup>138</sup> *Sutter* ignores this express language. Furthermore, nothing in *Weaver* hints that common stock might at some time be excluded from classification as a security.

Third, *Weaver* should be read as standing only for the proposition that when other federal regulations adequately protect the parties, the securities laws need not be applied.<sup>139</sup> In so holding, the Supreme Court merely followed its earlier decision in *International Brotherhood of Teamsters v. Daniel*,<sup>140</sup> which held that noncontributory pension plans do not involve securities since

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136. 637 F.2d 157, 164 (3d Cir. 1980), *rev'd*, 455 U.S. 551, 560 (1982).

137. 455 U.S. 551, 558-59 (1982) (emphasis added).

138. *Id.* at 556 (emphasis added).

139. *Arnold, Marine Bank v. Weaver: New Guidance on What Is Not a Security*, 53 OKLA. B.J. 2199, 2202 (1982) (The Supreme Court "abstained from a *Howey* type analysis as to the certificate of deposit's status. Instead, it focused primarily on the perceived lack of need for application of the antifraud provisions of the federal securities laws.").

140. 439 U.S. 551 (1979).

the area is already adequately regulated by ERISA.<sup>141</sup> No comparable regulation covers stock in a sale of business transaction. Moreover, it is not unfair to read *Weaver* as indicating that, absent federal banking regulation, certificates of deposit will be considered securities.

Additionally, *Sutter's* conclusion that *Weaver* provides support for excluding from the securities laws an instrument that is specifically listed in a definitional section of the '34 Act raises significant problems. According to *Sutter*, *Weaver* held that a certificate of deposit is a type of note.<sup>142</sup> Notes are listed in the definitional section of the '34 Act as a type of security; therefore, *Weaver* rejects the literalist approach by excluding a specifically listed instrument from the coverage of federal securities laws.

A close reading of *Weaver*, however, shows that the Third Circuit initially found that a certificate of deposit is not explicitly excluded from '34 Act coverage because it is not currency and because it has a maturity exceeding nine months.<sup>143</sup> The court further concluded that the certificate was a functional equivalent of the withdrawable capital shares of a savings and loan association,<sup>144</sup> which the Supreme Court had recognized as securities in *Tcherepnin v. Knight*.<sup>145</sup> The court also reasoned that, from an investor's standpoint, a certificate of deposit is no different than any other long-term obligation (bond or note).<sup>146</sup> In reversing the circuit court, the Supreme Court supplemented its main argument, outlined above, by noting that in *Tcherepnin* the withdrawable capital shares were much more like "ordinary shares of stock"<sup>147</sup> than are certificates of deposit.

Unlike shares of stock, certificates of deposit are not specifically listed in the '34 Act's definitional provision.<sup>148</sup> But even if one accepts *Sutter's* premise that a certificate of deposit is the equivalent of a note and that, therefore, *Weaver* does exclude from '34 Act coverage an instrument

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141. In *Daniel* the Court noted:

The existence of this comprehensive legislation governing the use and terms of employee pension plans [ERISA] severely undercuts all arguments for extending the Securities Acts to non-contributory, compulsory pension plans. Congress believed that it was filling a regulatory void when it enacted ERISA, a belief which the SEC actively encouraged. Not only is the extension of the Securities Acts by the court below unsupported by the language and history of those Acts, but in light of ERISA it serves no general purpose.

*Id.* at 569-70.

142. 687 F.2d 197, 200 (7th Cir. 1982).

143. 637 F.2d 157, 164 (3d Cir. 1980), *rev'd*, 455 U.S. 551 (1982). Section 3(a)(10) of the '34 Act explicitly excludes from the definition of securities any note "which has a maturity at the time of issuance of not exceeding nine months."

144. 637 F.2d 157, 164 (3d Cir. 1980), *rev'd*, 455 U.S. 551 (1982).

145. 389 U.S. 332 (1967).

146. 637 F.2d 157, 164 (3d Cir. 1980), *rev'd*, 455 U.S. 551 (1982).

147. 455 U.S. 551, 557 (1982) (emphasis added).

148. The words "certificate of deposit, for a security" do appear in § 3(a)(10) of the '34 Act, but this is a different type of instrument than a bank's certificate of deposit, which refers to "instruments issued by protective committees in the course of corporate reorganizations." *Id.* at 557 n.5 (quoting *Canadian Imperial Bank of Commerce v. Fingland*, 615 F.2d 465, 468 (7th Cir. 1980)).

specifically listed in the definitional section, there are many sound reasons why stock should not be treated in the same manner as notes.<sup>149</sup>

The first reason relates to the nature of the instruments. Unlike stock, which is the prototypical investment medium used to raise corporate capital and to transfer corporate ownership, notes have many commercial functions totally unrelated to corporate ownership, investment, or control, and frequently exist completely outside the enterprise environment—for example, a consumer loan or a home mortgage.<sup>150</sup>

Second, Congress has implicitly recognized the distinction between notes and stocks by providing statutory exemption for notes, but not for stock.<sup>151</sup> Similarly, the new American Law Institute Code's proposed definitions suggest a commercial-investment dichotomy for the definition of a note—"investment" notes constitute securities, while "commercial" notes do not—but not for the definition of stock.<sup>152</sup>

Third, Congress clearly did not intend the term "note" to be literally applied in all instances. The exemptions noted above are indicative of congressional intent. Further, even before the '33 Act was passed, courts held that certain types of notes were not securities. For example, in *Cecil B. De Mille Productions v. Woolery*,<sup>153</sup> a 1932 decision, the court held that an ordinary note not offered to the public or sold to an underwriter for resale was not a security requiring permission for sale under the California blue sky law.<sup>154</sup> On the other hand, no pre-1933 case has been located holding that corporate stock in any context is not a security.<sup>155</sup> Therefore, Congress probably did not contemplate the result accomplished by the sale of business doctrine: the transformation of common stock—the classic security—into a nonsecurity.

For judges wishing to exclude certain types of notes, such as those signed

149. The reasons given for distinguishing stock from notes also should serve to distinguish cases concerning notes, such as *Exchange Nat'l Bank v. Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976), in which Judge Friendly utilized the "context otherwise requires" argument, stating that in some contexts a note need not be a security. *Id.* at 1138; see also *Golden v. Garafalo*, 678 F.2d 1139, 1149 (2d Cir. 1982) (Lumbard, J., dissenting).

150. See *Bronstein v. Bronstein*, 407 F. Supp. 925, 930 (E.D. Pa. 1976); see also Comment, *The Sale of a Close Corporation*, *supra* note 12, at 768-69:

Notes are normally held by the lender as evidence of a loan. On the other hand, they are often procured for investment purposes as is usually the case in corporate debt offerings. By contrast, the purchase of common stock represents the purchase of ownership in the issuing company. While stock offerings can be a capital-raising device, the proceeds collected by the issuer are not on loan from the shareholder. There are no interest terms or repayment schedules; rather, the stockholder makes money on his purchase by receiving dividends or re-selling his ownership interest at an appreciated value.

In the case of close corporations, stock is acquired "for the purpose of acquiring an interest in a profit-making venture," not for the purpose of making a commercial loan. The commercial-investment dichotomy is not inherently present, and thus not a viable test for determining whether a given stock transaction is a security within the purview of the Acts.

151. For example, § 3(a)(10) of the '34 Act, 15 U.S.C. § 78c(a)(10) (Supp. V 1981), specifically exempts notes with a maturity not exceeding nine months from the definition of security.

152. FED. SEC. CODE § 202(150)(B)(iii) (1980).

153. 61 F.2d 45 (9th Cir. 1932).

154. *Id.* at 47.

155. See GEN. DIG. 1907-1916, 1917-1926, and 1927-1936, Licenses #18½.

by consumers purchasing goods on credit, from the coverage of the '33 and '34 Acts, this Article suggests that the "context otherwise requires" approach be scrapped in favor of the statutory interpretation approach of *Holy Trinity*.<sup>156</sup> As discussed above, under *Holy Trinity* a court can disregard the wording of a statute if literal application of the wording would "lead to injustice, oppression or an *absurd consequence*."<sup>157</sup> Although it might be absurd to say that a promissory note signed by a consumer who purchases a car on credit, or a commercial loan made by a bank, constitutes a security, it is nearly impossible to envision a situation in which it would be absurd to hold that garden-variety common stock is a security. Thus, *Holy Trinity*, properly applied, shows that although a literalist approach is sometimes inappropriate to define "notes" in the '33 and '34 Acts, it is appropriate when defining stock.

The foregoing discussion adequately refutes *Sutter's* reliance on *Weaver*, but for one point. The *Weaver* court does mention the "context otherwise requires" argument, noting at one point that "[t]he definition of 'security' in the 1934 Act provides that an instrument which seems to fall within the broad sweep of the Act is not to be considered a security if the context otherwise requires."<sup>158</sup> However, as the preceding analysis of the opinion indicates, this statement simply is not an integral part of the rationale of the decision. The case was decided on the ground that an alternative form of federal regulation was available to protect the plaintiffs. The reference to the "context" argument was dicta, at most. Moreover, this single conclusory sentence cannot be taken as a definitive statement on this very complicated issue. Had the Court intended to rule on the validity of the "context" argument, it would certainly have mentioned that its new statement flatly contradicted its prior position in *SEC v. National Securities, Inc.*<sup>159</sup>

In summary, advocates of the sale of business doctrine have concocted no convincing arguments to demonstrate that common stock should be excluded from the statutory definition of security. The statutory wording is clear, and neither *Forman* nor *Weaver* provides precedent for application of the "context" clause to remove stock from the definition.

#### B. *Is the "Economic Realities" Test Universally Applicable?*

Even if one accepts the proposition that stock should be excluded from the definition of security under certain circumstances, sale of business doctrine proponents must still establish a rationale for allowing stock to be characterized as a security to "investors," but not to "entrepreneurs." Most courts adopting the doctrine seek to achieve this goal by utilizing the three-

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156. *Church of the Holy Trinity v. United States*, 143 U.S. 457 (1892).

157. *Id.* at 461 (emphasis added).

158. 455 U.S. 551, 558 (1982).

159. See *supra* note 108 and accompanying text.

part *Howey* test.<sup>160</sup> These courts argue that *Forman*, when read with *Howey*, indicates that in determining whether a security is present, the key is always the economic reality of the underlying transaction, not the label on the instrument.<sup>161</sup>

If the *Howey* test is universally applied, entrepreneurs can never purchase a security because they buy with the thought of controlling the business and, therefore, do not intend to profit solely through the efforts of others, the third-prong of the *Howey* test. Investors, on the other hand, do rely on the efforts of others, so the stock purchased constitutes a security.

The arguments suggesting that the three-pronged *Howey* approach is the sole test to determine the existence of a security do not withstand scrutiny. Universal application of this test is inconsistent with the '33 and '34 Acts' definitional sections, which are premised on the listing of instruments and do not contain any sort of transactional test.<sup>162</sup> Further, application of a transactional analysis substantially undercuts Congress' explicit listing of stock as a security in both Acts.<sup>163</sup> In *Exchange National Bank v. Touche Ross & Co.*, a Second Circuit case that considered whether a note was a security, Judge Friendly questioned the broad application of the *Howey* test, concluding that "the best alternative now available may lie in greater recourse to the statutory language."<sup>164</sup>

Joining other courts,<sup>165</sup> the Second Circuit in *Garafalo* refused to extend the *Howey* test to corporate stock:

We agree fully with Judge Friendly that however great the merits of the *Howey* test in determining what falls within the catch-all phrase "investment contract," it is of little help in determining the meaning of more specific words which refer to instruments with commonly agreed upon characteristics such as "stock."

. . . Congress may have had good reason to rely on conventional commercial and legal criteria for classifying such instruments. At least the use of such criteria avoids the danger of allowing the application of the '33 and '34 Acts to turn on uncertain and slippery factors, case by case.<sup>166</sup>

The *Howey* test, as originally formulated, defined the term "investment contract"; it was not intended as a universal definition for securities generally. The *Forman* Court equated the *Howey* formulation with "the ordinary concept of a security."<sup>167</sup> Relying on this statement, sale of business doctrine

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160. See *supra* note 28 and accompanying text.

161. *King v. Winkler*, 673 F.2d 342, 344 (11th Cir. 1982); *Somogyi v. Butler*, 518 F. Supp. 970, 985 (D.N.J. 1981); see also *Seldin I*, *supra* note 10, at 666, 668.

162. *Dillport, Restoring Balance*, *supra* note 101, at 120; Comment, *Securities Regulation*, *supra* note 123, at 121.

163. Note, *Purchase of Stock*, *supra* note 12, at 1251.

164. 544 F.2d 1126, 1337 (2d Cir. 1976); see also *Movielab, Inc. v. Berkey Photo, Inc.*, 452 F.2d 662, 663-64 (2d Cir. 1971).

165. See *Sterling Recreational Org. v. Segal*, 537 F. Supp. 1024, 1027 (D. Colo. 1982); *Titsch Printing, Inc. v. Hastings*, 456 F. Supp. 445, 449 (D. Colo. 1978); *Bronstein v. Bronstein*, 407 F. Supp. 925, 929 (E.D. Pa. 1976).

166. 678 F.2d 1139, 1145 (2d Cir. 1982).

167. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 848 (1975).



proponents claim that the *Howey* test has been expanded to universal application.<sup>168</sup> As noted in *Garafalo*, however, the term "investment contract" was meant to constitute a "catch-all" category to include all unique devices that promoters might use to sell instruments possessing the same general characteristics as normal securities, but bearing different labels.<sup>169</sup> The statement quoted in *Forman* does not imply that the *Howey* formulation constitutes the test governing all securities other than an investment contract.

Courts<sup>170</sup> seeking to establish *Howey* as the universal test to determine the presence of a security also point to the *Forman* Court's language indicating that no distinction exists between an investment contract and an "instrument commonly known as a 'security.'"<sup>171</sup> Because an investment contract is commonly accepted as a variety of security, this statement has little meaning. It is analogous to saying that no distinction exists between a poodle and an animal commonly known as a dog. There is also little or no difference between common stock and an "instrument commonly known as a security," but this does not mean that the test for the presence of stock (an instrument carrying a right to vote, a right to receive dividends, an opportunity for appreciation in value, and so on) is the universal test for the presence of a security. In short, the Court merely stated that investment contracts are a common type of security, not that the definition of the term "investment contract" is coextensive with the much broader concept of securities.<sup>172</sup>

Also, sale of business doctrine cases<sup>173</sup> cite *Forman*'s statement that the *Howey* test embodies all the essential attributes that run through all the Court's decisions on securities.<sup>174</sup> This is not surprising for two reasons. First, such a statement is analogous to saying that a poodle embodies all the essential attributes that run through the definition of a "dog." The same statement could be made regarding the test to determine the presence of a "stock" or a "bond" or a "participation interest," because an investment contract is one of the broadest categories of security. Furthermore, all prior Supreme Court cases defining a security concerned investment contracts, so naturally the *Howey* test pervades them all.<sup>175</sup>

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168. *Id.*; *Golden v. Garafalo*, 521 F. Supp. 350, 357 (S.D.N.Y. 1981), *rev'd*, 678 F.2d 1139 (2d Cir. 1982); see also *Deacon & Prendergast, Defining a "Security" After the Forman Decision*, 11 PAC. L.J. 213, 217-18 (1980).

169. The investment contract is the utility infielder of securities law. An instrument will be deemed an investment contract only if it sufficiently resembles "transactions that are indisputably covered by the antifraud provisions, such as the purchase of corporate stocks and bonds." *Sonnenschein, Federal Securities Laws Coverage of Note Transactions; The Antifraud Provisions*, 35 BUS. LAW. 1567, 1587 (1980) (emphasis added). The *Howey* test, according to *Garafalo*, is properly limited to "unique or idiosyncratic instruments." 678 F.2d 1139, 1144 (2d Cir. 1982).

170. *Golden v. Garafalo*, 521 F. Supp. 350, 357 (S.D.N.Y. 1981), *rev'd*, 678 F.2d 1139 (2d Cir. 1982).

171. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975).

172. *Id.* at 851-52.

173. *Golden v. Garafalo*, 521 F. Supp. 350, 357 (S.D.N.Y. 1981), *rev'd*, 678 F.2d 1139 (2d Cir. 1982).

174. 421 U.S. 837, 852-53 (1975).

175. See cases cited *supra* note 5; see also *Dillport, Restoring Balance*, *supra* note 101, at 115.

To construe the *Forman* Court's decision as holding the *Howey* formulation to be the universal test to determine the presence of a security is to render one-half of the *Forman* opinion completely meaningless,<sup>176</sup> because the first half of the opinion concentrated on the definition of "stock" and defined it not in *Howey*'s terms but in terms of the normal characteristics of stock.<sup>177</sup> Only in the second half of the opinion, in which the Court considered investment contracts, did it apply the *Howey* test. If the *Howey* test is the universal criterion for determining a security, one must ask why the Supreme Court's most recent decision, *Marine Bank v. Weaver*, held, without applying *Howey*,<sup>178</sup> that a certificate of deposit was not covered by the securities laws. Finally, it is impossible to conclude that Congress intended *Howey* to be the universal test for a security because the *Howey* three-prong test was constructed largely out of whole cloth by Justice Murphy in *SEC v. W. J. Howey Co.* in 1946, twelve years after the '34 Act was passed.<sup>179</sup>

In summary, neither the Supreme Court nor Congress has sanctioned the use of the *Howey* three-prong transactional analysis as a substitute for Congress' instrument-oriented definitional approach in the '33 and '34 Acts. The

176. *Golden v. Garafalo*, 678 F.2d 1139 (2d Cir. 1982):

*Forman* applied a two-part, seriatim test. The first part asked whether the shares in Riverbay were "stock" and looked to the characteristics usually associated with such instruments: right to dividends, transferability, right to pledge, voting rights in proportion to shareholdings, and ability to appreciate in value. . . . These criteria seem more concerned with legal status than "economic reality." Having first determined that the Riverbay shares were not stock, the Court went on to determine whether they were an "investment contract" and applied the three-pronged "economic reality" test of *Howey*. The actual analysis utilized in *Forman*, therefore, is inconsistent with the sale of business doctrine. If "economic reality" is the universal jurisdictional test under the Acts, no matter what the facial or legal character of the instrument, there was no need to examine whether the Riverbay shares were stock according to conventional criteria, since an affirmative answer would have been irrelevant. The doctrine thus seems to assume that a major part of the discussion in *Forman* was pointless.

177. *Id.* at 1144. The court in *Forman* noted that

[d]espite their name, they lack what the Court in *Tcherepnin* deemed the most common feature of stock: the right to receive "dividends contingent upon an apportionment of profits." 389 U.S., at 339. Nor do they possess the other characteristics traditionally associated with stock: they are not negotiable; they cannot be pledged or hypothecated; they confer no voting rights in proportion to the number of shares owned; and they cannot appreciate in value.

421 U.S. 837, 851 (1975).

Thus, *Forman*'s approach to the definition of a security was instrument oriented. The sale of business doctrine perverts *Forman*, which used various aspects of the transaction to determine whether the instrument was a security, by using *Howey* to do the reverse—emphasize the status of the transaction, not the instrument. Dillport, *Restoring Balance*, *supra* note 101, at 115–16.

178. 455 U.S. 551, 557–59 (1982). The Court did apply *Howey* in the second half of its opinion to determine whether a "separate agreement" between the parties that entitled the plaintiffs to use the barn and pastures of the slaughterhouse business in question constituted an "investment contract." *Id.* at 559–60.

This is consistent with the observation of Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 HASTINGS L.J. 219, 285 (1974), that the *Howey* test has been applied to "nonobvious securities (unlike stocks and bonds)." Stocks are "obvious securities" to which the *Howey* test has no application.

179. In *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 146–55 (1971), Professor Long demonstrated that the bulk of the case law cited in *Howey* did not support the three-part test that Justice Murphy devised. Long traced the roots of the *Howey* test back to *Lewis v. Creasey*, 198 Ky. 409, 248 S.W. 1046 (1923), in which the test had been promulgated as the definition of a security, rather than of an investment contract. Long also noted that, before *Howey* was decided in 1943, the test had received very little support, most of which came after the passage of the '33 and '34 Acts.

*Howey* formulation determines the presence of an investment contract, but not the presence of other forms of securities.<sup>180</sup>

### C. Did Congress Intend to Protect Only "Investors"?

Perhaps realizing the weakness of the argument for a universal application of the *Howey* test, the basis of its decision in *Poloway*, the Seventh Circuit in *Sutter v. Groen* sought to accomplish the same result—exclusion of stock purchased by entrepreneurs from the definition of security—by another means. The court's new argument is more direct: "We must ask . . . what class of people Congress wanted to protect by enacting the Security Exchange Act, and in particular section 10(b). The answer is not in doubt: investors."<sup>181</sup> The court referred to an impressive array of legislative history to support its conclusion<sup>182</sup> and inferred that the Acts were not meant to protect purchasers or sellers of controlling interests in corporations who are not "investors" but instead are "entrepreneurs."<sup>183</sup>

*Sutter's* investor-entrepreneur dichotomy has several flaws. First, the purchaser of a controlling interest in a business is an investor. One of the few cases attempting to define explicitly the term "investor" is the landmark case, *Kardon v. National Gypsum Co.*<sup>184</sup>

In *Kardon* the Slavin brothers owned half of the stock in two affiliated corporations. The Kardons, father and son, owned the other half.<sup>185</sup> The Slavins made a secret deal to sell the corporate properties to others for over 1.5 million dollars. Without telling the Kardons of this deal, the Slavins purchased their interest in the corporations for approximately 500 thousand dollars.<sup>186</sup> The sale of business doctrine would likely lead a court to hold that when the Kardons sold their stock to the Slavins, they did not sell securities because they were entrepreneurs rather than investors. The Kardons held a fifty percent interest in the corporations. They could take an active role in the

180. Karjala, *Realigning Federal and State Roles in Securities Regulation Through the Definition of a Security*, 1982 U. ILL. L. REV. 413, 425.

181. 687 F.2d 197, 201 (7th Cir. 1982).

182. E.g., S. REP. NO. 792, 73d Cong., 2d Sess. 2 (1934) (message of President Roosevelt calling for enactment of '34 Act, *inter alia*, "for the protection of investors" (emphasis added)); *id.* at 5 (Report of the Senate Committee on Banking and Currency describing the goal of the legislation as minimization of speculation and elimination of secrecy surrounding corporations "which invite the public to purchase their securities"); *id.* at 4, 6-7, 11-12 (Senate Committee's Report contains references to "disastrous results to investors," "tremendous losses to the investing public," and so forth) (emphasis added); *see also* SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953) (purpose of '33 Act "is to protect investors by promoting full disclosure of information"); SEC v. International Chem. Dev. Corp., 469 F.2d 20, 26 (10th Cir. 1972) (purpose of rule 10b-5 of '34 Act and § 17(a) of '33 Act "is protection of investors from fraudulent practices"); *Ruszkowski v. Hugh Johnson & Co.*, 302 F. Supp. 1371, 1376 (W.D.N.Y. 1969) (purpose of § 12(2) of '33 Act is "to protect the investor from misstatements of material fact"); Hanna & Turlington, *Protection of the Public Under the Securities Exchange Act*, 21 VA. L. REV. 251, 276 (1935) (purpose of '34 Act is to "improve the position of the average investor"); Note, *Legislation: The Securities Act of 1933*, 33 COLUM. L. REV. 1220, 1223 (1933) (purpose of '33 Act is to enforce "disclosure to the investor of the elements necessary to insure an intelligent and informed judgment").

183. 687 F.2d 197, 201 (7th Cir. 1982).

184. 69 F. Supp. 512 (E.D. Pa. 1946).

185. 73 F. Supp. 798, 800 (1947).

186. *Id.* at 801.

management of corporate affairs. Yet, the *Kardon* court refused to hold that "two men who have acquired ownership of the stock of a corporation are not investors merely because they own half of the total issue."<sup>187</sup>

Actually, the purchaser of a business may well be both an investor and an entrepreneur. Consider Judge Posner's statement in *Sutter*:

There is a clear difference in principle between an investor and an entrepreneur; and while sometimes a person is both at once, often he is one or the other. A judge who owns IBM stock is an investor but not an entrepreneur; the corner grocer is a food entrepreneur rather than an investor in the food business, though a conglomerate corporation that owned a chain of grocery stores might be both.<sup>188</sup>

In attempting to clarify the matter, Judge Posner has highlighted the bankruptcy of the investor-entrepreneur dichotomy underlying the sale of business doctrine. While first asserting "a clear difference in principle" between the two classes, he immediately admitted that the same person may play both roles simultaneously.<sup>189</sup> Presumably, the sale of business doctrine would not apply to such a mixed entrepreneur because of his partial investment intent. However, the fact pattern commonly governed by the sale of business doctrine—the sale of an ongoing business through stock transfer—appears to present precisely such a mixed situation. Judge Posner opined that "the corner grocer is a food entrepreneur rather than an investor in the food business."<sup>190</sup> Although this may be true, the argument does not address the issue presented by the sale of business doctrine—the sale by the corner grocer of his ongoing business by transferring a controlling block of its stock. Certainly in such a situation one cannot say that the buyer is solely an entrepreneur and is in no sense an investor.

In one sense the mixed purchaser is an investor since the price he pays reflects not only the market value of the underlying assets, such as the equipment, inventory, fixtures and leasehold, but also an additional amount for the value of the business itself—that is, goodwill. The goodwill figure is frequently a substantial portion of the purchase price, certainly resulting from the efforts (past, and in some cases, future) of others—the seller.<sup>191</sup> Judge Posner essentially admitted this distinction by noting: "[I]f Happy Radio had purchased a radio transmitter from Bret Broadcasting and had later discovered that the Groens had misrepresented the value of the transmitter, Happy Radio could not complain that it had been tricked into making a bad investment in any sense relevant to the Securities Exchange Act."<sup>192</sup> Though

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187. 69 F. Supp. 512, 514 (E.D. Pa. 1946) (emphasis added).

188. 687 F.2d 197, 201 (7th Cir. 1982).

189. See *United States v. Tracinda Inv. Corp.*, 477 F. Supp. 1093, 1099 (C.D. Cal. 1979) ("Acquiring the stock of a company for the purpose of control and acquiring the stock for the purposes of investment are not necessarily inconsistent, nor are they mutually exclusive concepts in the practical business world.").

190. 687 F.2d 197, 201 (7th Cir. 1982).

191. See *supra* notes 24–28 and accompanying text.

192. 687 F.2d 197, 201–02 (7th Cir. 1982).

this is true, it begs the question since it does not involve the basic component in sale of business cases—the sale of a business. In the transmitter case, no business is being bought or sold. A tangible asset is being sold for a price, an event that occurs millions of times daily. Presumably any misrepresentation can be adequately remedied through an action for common-law fraud or breach of warranty. On the other hand, in sale of business cases the purchaser pays not only the value of the assets, but also a premium representing the value of the ongoing business. By purchasing this premium, the purchaser makes an investment.

In another sense the purchaser of a business is an investor because he may be partly motivated “by the same expectations of profit or capital appreciation that induce all investors to part with their money.”<sup>193</sup> As the Second Circuit explained in *Garafalo*:

The sale of business doctrine in the end turns upon the distinction between commercial and investment transactions. That is a distinction which, in the context of transfers of corporate stock, appears to us to be of most dubious value. For example, plaintiffs in this case no doubt hoped to reap the business' profits in the form of salary, but that form is dictated by tax laws which subject dividends to double taxation. Who is to say that plaintiffs did not hope at some future date to resell the shares and realize an appreciation in their value, like investors in “growth” stocks which pay little or no dividends. The allegation in this case is that plaintiffs paid defendant over \$100,000 more than the net asset value of the business. In truth, purchasers of a business rightly regard themselves as investors as well as managers. Transfers of corporate control frequently are motivated by a hope for capital gains resulting from improved management, and it is altogether artificial to classify such transactions as exclusively commercial.<sup>194</sup>

Even if some sensible criteria can be developed to distinguish investors from entrepreneurs, thus placing them in legally separate categories, *Sutter*'s dichotomy fails because it incorrectly assumes that the securities laws are meant to protect only investors.<sup>195</sup> Although a major goal of the '33 and '34 Acts is to protect the classic “small investor”—the “little man” buying a few shares of General Motors stock through the impersonal marketplace—their remedial purposes are much broader.

Although Congress' main focus in passing the Acts may have been on the public investor because of the attention accorded the Wall Street activity in 1929, privately negotiated business transactions are also covered by the anti-

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193. Comment, *The Sale of a Close Corporation*, *supra* note 12, at 759.

194. 678 F.2d 1139, 1146 (2d Cir. 1982).

195. In *Sutter* Judge Posner supported this proposition solely by repeated references to the use of the term “investor” in the Senate report accompanying the '34 Act. The frequent referral to investor protection in the report is not surprising, of course, since it accompanied and described a bill that, according to the committee report, “provide[s] for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes.” S. REP. NO. 792, 73rd Cong., 2d Sess. 1 (1934). Given the purposes stated above it is apparent that the report makes frequent reference to investor protection since buyers and sellers of stock on stock exchanges and in the over-the-counter market are investors in the classic sense.

fraud provisions of section 10(b).<sup>196</sup> Simply because most sale of business cases concern purchases through such privately negotiated transactions is no reason to attempt to exclude them from securities law coverage by suddenly removing common stock from the definition of security.

The sale of business doctrine, carried to its logical conclusion, effectively precludes many shareholders in close corporations from claiming the anti-fraud protections of the securities laws. A traditional feature of a close corporation is that investors take an active role in the affairs of the company.<sup>197</sup> But under the sale of business doctrine, this active role may well turn the investors into entrepreneurs, who are not entitled to protection because their stock is not a security. In so providing, the sale of business doctrine attempts to change the settled law that close corporations do come within the purview of the antifraud provision of the securities acts, especially section 10(b).<sup>198</sup>

The language of section 10(b) indicates that its purpose is broader than merely investor protection by explicitly prohibiting contravention of rules promulgated by the SEC "*in the public interest or for the protection of investors.*"<sup>199</sup> Obviously, Congress believed it in the public interest to pass rules for purposes other than mere protection of investors.<sup>200</sup>

The *Sutter* court's niggardly interpretation of the purposes of the securities laws is not only inconsistent with the plain wording of section 10(b), but it is also contrary to established case law recognizing several important purposes of the '33 and '34 Acts beyond mere protection of investors. Various courts have held that the Acts effectuate such purposes as keeping the channels of interstate commerce free from fraudulent schemes,<sup>201</sup> maintaining the purity of the security transaction and of the trading process,<sup>202</sup> achieving a high standard of business ethics,<sup>203</sup> instilling confidence in the securities market,<sup>204</sup> ensuring fair dealing in securities transactions,<sup>205</sup> and simply

196. See *Golden v. Garafalo*, 678 F.2d 1139, 1146 (2d Cir. 1982); *Matheson v. Armbrust*, 284 F.2d 670, 674 (9th Cir. 1960), *cert. denied*, 365 U.S. 870 (1961); *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195, 201 (5th Cir. 1960); *Errion v. Connell*, 236 F.2d 447, 453 (9th Cir. 1956); *Fratt v. Robinson*, 203 F.2d 627, 630-31 (9th Cir. 1953); *Bronstein v. Bronstein*, 407 F. Supp. 925, 931 (E.D. Pa. 1976). See generally Latty, *The Aggrieved Buyer or Seller or Holder of Shares in a Close Corporation Under the S.E.C. Statutes*, 18 LAW & CONTEMP. PROBS. 505 (1953).

197. H. HENN, LAW OF CORPORATIONS 506 (2d ed. 1970).

198. See, e.g., *Superintendent of Ins. v. Bankers Life & Cas.*, 404 U.S. 6 (1971); *Golden v. Garafalo*, 678 F.2d 1139, 1146-47 (2d Cir. 1982); *Hackbart v. Holmes*, 675 F.2d 1114, 1117 n.3 (10th Cir. 1982); *Thomas v. Duralite Co.*, 524 F.2d 577 (3d Cir. 1975); *Bronstein v. Bronstein*, 407 F. Supp. 925, 931 (E.D. Pa. 1976); *Dauphin Corp. v. Davis*, 201 F. Supp. 470, 472 (D. Del. 1972); *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947).

199. § 10(b), 15 U.S.C. § 78j(b) (Supp. V 1981) (emphasis added).

200. S. REP. NO. 792, 73d Cong., 2d Sess. 1 (1934).

201. *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 590 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974).

202. *Superintendent of Ins. v. Bankers Life & Cas.*, 404 U.S. 6, 9-10 (1971); *Rochelle v. Marine Midland Grace Trust Co.*, 535 F.2d 523, 532 (9th Cir. 1976).

203. *United States v. Naftalin*, 441 U.S. 768, 775 (1979); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186-87 (1963); *United States v. Newman*, 664 F.2d 12, 18 (2d Cir. 1981); *Tomera v. Galt*, 511 F.2d 504, 510 (7th Cir. 1975); *E.F. Hutton & Co. v. Penham*, 547 F. Supp. 1286, 1295 (S.D.N.Y. 1982).

204. *Sargent v. Genesco, Inc.*, 492 F.2d 750, 760 (5th Cir. 1974).

205. *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787, 793 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970); *SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 858, 860 (2d Cir. 1968), *cert. den. sub. nom. Coates v. SEC*, 394 U.S. 976 (1969).

protecting the interests of the general public.<sup>206</sup> To achieve these varied purposes, courts have found it necessary to conclude that the securities laws protect not only the average investor, but many other entities as well, including intermediaries,<sup>207</sup> transfer agents,<sup>208</sup> creditors,<sup>209</sup> speculators,<sup>210</sup> and even the "powerful and sophisticated."<sup>211</sup>

In short, although a major purpose of the federal securities laws is to protect investors, a recent Second Circuit opinion concluded that "we have not found any case holding that this [investor protection] was its [section 17(a)'s] sole purpose . . . ."<sup>212</sup> Therefore, *Sutter* is not only incorrect in concluding that the purchaser or seller of a controlling interest in a business is not an investor, but its further conclusion—that an entrepreneur is not protected by the Securities Acts because they were enacted to benefit only investors—is specious.<sup>213</sup>

#### IV. WHAT IS THE NET EFFECT OF THE SALE OF BUSINESS DOCTRINE ON THE PARTIES, THE COURTS, AND THE ENFORCEMENT OF THE SECURITIES LAWS?

Apart from its theoretical flaws, the sale of business doctrine has the net effect of fostering fraudulent conduct without producing any countervailing substantive advantages.

##### A. Procedural Anomalies

A particularly troublesome aspect of the sale of business doctrine is that it provides causes of action to or against some parties to the sale of a business, but not to or against others. This anomaly results from the odd conclusion that the same instruments—shares of common stock—are securities when transferred to some parties to the transaction, but not others. This discrepancy raises procedural and jurisdictional anomalies that complicate the litigation and promote differing treatment of similarly situated parties.

Most reported sale of business doctrine cases concern fraud suits by disgruntled purchasers against dominant or major selling shareholders.<sup>214</sup> To illustrate the basic problem, assume *S*, an 80 percent shareholder and *SI*, a 20 percent shareholder, sell their ongoing business by stock transfer to *B*, who

206. S. REP. NO. 792. 73d Cong., 2d Sess. 9 (1934).

207. *United States v. Naftalin*, 441 U.S. 768, 771-79 (1979).

208. *United States v. Brown*, 555 F.2d 336, 338 (2d Cir. 1977).

209. *Superintendent of Ins. v. Bankers Life & Cas.*, 404 U.S. 6, 10 (1971); *United States v. Gentile*, 530 F.2d 461, 467 (2d Cir.), *cert. denied*, 426 U.S. 936 (1976).

210. *SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 849 (2d Cir. 1968), *cert. den. sub. nom. Coates v. SEC*, 394 U.S. 976 (1969); *O'Connor v. Dean Witter*, 529 F. Supp. 1179, 1186 (S.D.N.Y. 1982).

211. *Lehigh Valley Trust Co. v. Central Nat'l Bank*, 409 F.2d 989, 992 (5th Cir. 1969); *see also infra* notes 261-68 and accompanying text.

212. *United States v. Brown*, 555 F.2d 336, 338 (2d Cir. 1977).

213. Predicating the definition of security on the concept of "control" when corporate stock is involved logically leads to the unacceptable conclusion that a "shark" in a tender offer is not buying securities and, therefore, is not governed by the Williams Act. Karjala, *Realigning Federal and State Roles in Securities Regulation Through the Definition of a Security*, 1982 U. ILL. L. REV. 413, 423.

214. *See Seldin I*, *supra* note 10, at 679, and cases discussed therein.

purchases the entire 100 percent. A dispute subsequently arises in which both sides claim material misrepresentations in connection with the sale. Neither *B* nor *S* can maintain a cause of action under the federal securities laws because they are controlling sellers and buyers. The sale of business doctrine holds that the stock they exchanged is not a security. Because *SI* holds only 20 percent of the stock, however, he is an investor and thus can bring suit under the federal securities laws. *SI* can sue both *S* and *B*, though they cannot sue him. The sale of business doctrine dictates that the certificates of stock that were not securities for *S* and *B*, are securities for *SI*.

To illustrate further the effects of the application of the sale of business doctrine, assume that the following suits are generated: (1) *B* v. *S*; (2) *B* v. *SI*; (3) *S* v. *B*; (4) *S* v. *SI*; (5) *SI* v. *B*; and (6) *SI* v. *S*. If the sale of business doctrine is applied, federal securities law claims could be brought in suits (5) and (6), but not in suits (1) through (4).<sup>215</sup> Though the same instruments and the same transaction are the source of each suit, only when *SI*—the investor—is the plaintiff can the shares of stock be treated as securities and federal claims be asserted. The rationale for this result is that

[t]he minority stockholder who is not active in the management of the corporation views his stockholding interest as an investment rather than an indicium of ownership of a business. Such a stockholder does not sell in order to divest himself of ownership of a business but rather to make a profit or avoid or minimize a loss on his investment. Under the "purpose of the parties" test which has been utilized by all courts recognizing the sale of business doctrine, the sale by the passive minority stockholder would be the sale of a security.<sup>216</sup>

Labeling the same stock instruments as securities for some persons and purposes but not for others is a necessary by-product of the sale of business doctrine. If the shares are not imbued with this chameleon-like quality—the ability to be either a security or a nonsecurity, depending on their holder—minority shareholders such as *SI*, who are clearly investors, lose the protection of the securities laws merely because a buyer managed to purchase a controlling interest at one time.<sup>217</sup> Courts adopting the sale of business doctrine are determined to hold that the stock purchased by the buyer is not a security, but they cannot afford to leave the minority sellers of that same stock without securities law protection.

Additional complications arise because once the stock is deemed not to be a security when purchased in a controlling block, it must retain the ability to revert back into a security. Otherwise, the purchaser of a controlling interest would be able to evade the insider trading proscriptions of sections 10(b) and 16 of the '34 Act because he is not trading in securities.<sup>218</sup> Furthermore,

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215. See *id.* at 680.

216. *Id.*

217. *McGrath v. Zenith Radio Corp.*, 651 F.2d 458, 468 n.5 (7th Cir. 1981); *Stacey v. Charles J. Rogers, Inc.*, 542 F. Supp. 48, 50 (E.D. Mich. 1982); Comment, *Securities Regulation*, *supra* note 123, at 130.

218. See Note, *Purchase of Stock*, *supra* note 12, at 1255.



one may argue that management employees who share in the control of the company would not be protected by the Securities Acts in their capacity as shareholders because they did not purchase securities.<sup>219</sup>

The necessity of treating stock as securities for some persons and purposes but not for others causes major problems. Logistically, the six hypothetical permutations discussed above are likely to arise out of a single factual situation. After the original suit is filed, the other potential claims are likely to be raised through counterclaims or cross-claims. Thus, even though the evidence is identical, one party's claim may be tried under federal law while another's claim may be tried merely as a state fraud action. This situation raises the further possibility that the claims will be brought simultaneously in both state and federal court. If *B* sues *SI* in state court for fraud, *SI* might well retaliate by suing *B* for federal securities violations in federal court. The case could be tried in two courts under differing legal theories, with the possibility of inconsistent results. Since the evidence adduced at both trials will be virtually identical, the parties will be burdened and judicial resources will be wasted. Even if the claims are tried in a single court—*SI* sues *B* in federal court for securities law violations and *B* counterclaims under a common-law fraud theory—one can imagine a jury's confusion upon hearing the judge's instruction that the corporate stock certificates were securities when they left *SI*'s hands but not when they entered *B*'s. The more parties participating, the more incomprehensible the situation.

This underlying concept of the sale of business doctrine—that the presence of a security should be judged by a test that finds the same instrument a security at some times for some purposes, but not at other times for other purposes—has traditionally been rejected in federal securities law.<sup>220</sup> Even the sale of business doctrine's most enthusiastic supporter, Seldin, admits that the result has a "curious ring"<sup>221</sup> and can be "strained and artificial"<sup>222</sup> when both dominant and passive stockholders are signatories to a single sale agreement.

Additionally, no Supreme Court precedent exists for the "here today,

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219. See *Bronstein v. Bronstein*, 407 F. Supp. 925, 931 (E.D. Pa. 1976); see also Note, *Purchase of Stock* *supra* note 12, at 1254; Comment, *The Sale of a Close Corporation*, *supra* note 12, at 765.

220. See *Exchange Nat'l Bank v. Touche Ross & Co.*, 544 F.2d 1126, 1137 (2d Cir. 1976) ("Yet we see nothing in the statutes that would justify holding that the same note was a security when a borrower from a bank invoked federal law and not a security when the bank asserted this."); *Oakhill Cemetery v. Tri-State Bank*, 513 F. Supp. 885, 890 (N.D. Ill. 1981) (same transaction cannot be "deemed as involving a security as to some of the parties thereto, but not as to others."); see also Dillport, *Restoring Balance*, *supra* note 101, at 121 ("The orderly administration of the Acts will become unmanageable, however, if the status of an instrument is determined on the basis of the transaction in which it is transferred."); Hammett, *Any Promissory Note: The Obscene Security—A Search for the Non-Commercial Investment*, 7 TEX. TECH L. REV. 25, 48 (1975) (stating it is "unfortunate and erroneous" to hold "that a note's status as a security depends in part on whether its maker is a plaintiff or a defendant in any resulting lawsuit"); Note, *Sale of Business by Transfer of 100% of Corporate Stock Not Governed by Securities Laws*, 65 MARQ. L. REV. 487, 499 (1982).

221. Seldin I, *supra* note 10, at 681.

222. *Id.* n.107.

gone tomorrow" definition of a security espoused by the sale of business doctrine. The *Garafalo* court noted:

*Howey, Forman and Marine Bank* treat the determination of whether a particular instrument is a "security" under the '33 and '34 Acts as one which does not vary from time to time depending upon the relative holdings of the parties or their intention in a particular transaction. Only changes in the instruments themselves, and drastic ones, would convert the Riverbay shares [in *Forman*] into "stock." The sale of business doctrine, on the other hand, treats an instrument as a "security" for some purposes but not for others.<sup>223</sup>

### B. Tactical Anomalies

By applying the sale of business doctrine, courts intend to limit substantially the scope of coverage of the federal securities laws, particularly the antifraud provisions.<sup>224</sup> An expressed "advantage" of the doctrine is reduction of the caseload of the federal courts.<sup>225</sup> Indeed, the sale of business doctrine may be characterized as no more than the most recent manifestation of a growing judicial hostility to private causes of action under rule 10b-5.<sup>226</sup>

The key question is whether courts adopting the doctrine are simply following the Supreme Court's guidance in *Marine Bank v. Weaver* to avoid "casting the net of Rule 10b-5 liability farther than the Congress"<sup>227</sup> intended, or are adopting an unreasonably restrictive view of the remedial federal securities laws. The answer can be discerned by noting that sale of business doctrine courts are patently incorrect when they hold that purchasers or sellers of controlling interests do not need the protections of the federal securities laws<sup>228</sup> and that they are not the intended beneficiaries of those laws because they are not investors.<sup>229</sup>

For purposes of argument only, assume that entrepreneurs are not protected by the securities laws when they purchase corporate stock. One of the great unsolved mysteries of the sale of business doctrine is why courts bent on ousting entrepreneurs from the protective coverage of the federal securities laws choose to do so by refusing to label garden-variety common stock a security, yet concede that under different circumstances that stock can mystically "change its spots" and switch from a security to a nonsecurity. This tactical approach to the desired goal—reducing the scope of federal

223. *Golden v. Garafalo*, 678 F.2d 1139, 1143-44 (2d Cir. 1982).

224. Karjala, *Realigning Federal and State Roles in Securities Regulation Through the Definition of a Security*, 1982 U. ILL. L. REV. 413, 415.

225. *Sutter v. Groen*, 687 F.2d 197, 201 (7th Cir. 1982); *Golden v. Garafalo*, 678 F.2d 1139, 1147 (2d Cir. 1982) (Lumbard, J., dissenting); Note, *The Economic Realities of Defining Notes as Securities Under the Securities Act of 1933 and the Securities Exchange Act of 1934*, 34 U. FLA. L. REV. 400, 406 (1982) ("Increased judicial strain prompted by expanding securities litigation, however, has recently weakened absolute adherence to plain statutory language.").

226. See, e.g., *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (imposing "scienter" requirement on rule 10b-5 litigation); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (taking restrictive view of "purchaser or seller" requirement of § 10(b)).

227. *Sutter v. Groen*, 687 F.2d 197, 201 (7th Cir. 1982).

228. See *infra* notes 260-66 and accompanying text.

229. See *supra* notes 199-212 and accompanying text.

securities law coverage—is anomalous because two obvious legal doctrines, discussed below, would accomplish the same result by much more direct and less mystical routes.

### 1. *The Doctrine of Standing*

Under *Association of Data Processing Service Organizations v. Camp*,<sup>230</sup> a plaintiff wishing to assert a right under a federal statute has no standing to do so unless he can allege (1) that he has suffered some “injury in fact” and (2) that the interest sought to be protected is arguably within the zone of interests to be protected by the statute.<sup>231</sup> The key to the second part of the standing test, the “zone of interests,” is “whether the . . . statutory provision on which the claim rests properly can be understood as granting persons in the plaintiff’s position a right to judicial relief.”<sup>232</sup>

If under the sale of business doctrine entrepreneurs are correctly not deemed beneficiaries of the federal securities laws, the simplest route to the proper result is for the court to hold that entrepreneurs have no standing to sue under those laws.<sup>233</sup> The most obvious reason courts have chosen to take the tortuous, questionable sale of business doctrine route rather than the simpler, more direct standing route is because the law of standing under the federal securities laws clearly extends entitlement to sue beyond mere investors.<sup>234</sup>

### 2. *Implied Right of Action*

Identifying the intended beneficiaries of a statute should ring other bells, for this process is also a key part of a court’s determination whether to imply a

230. 397 U.S. 150 (1970).

231. *Id.* at 153–54; *see also* *Valley Forge Christian College v. Americans United for Separation of Church and State, Inc.*, 454 U.S. 464, 471–76 (1982); *Kirby v. United States Gov’t*, 675 F.2d 60, 64 (3d Cir. 1982); *Fentron Indus. v. National Shopmen Pension Fund*, 674 F.2d 1300, 1304 (9th Cir. 1982); *Lamoille Valley R.R. v. National Mediation Bd.*, 539 F. Supp. 237, 245–46 (D. Vt. 1982).

This two-part test is naturally applicable in suits brought under the federal securities laws. *E.g.*, *Spector v. L Q Motor Inns, Inc.*, 517 F.2d 278 (5th Cir. 1975), *reh’g denied*, 521 F.2d 815, *cert. denied*, 423 U.S. 1055 (1976); *Herpich v. Wallace*, 430 F.2d 792, 805 (5th Cir. 1970). The first element of the test represents the constitutional aspect of the standing doctrine, which derives from article III’s “case or controversy” requirement. The second element, relevant here, is the “prudential” aspect of the standing doctrine. *Valley Forge Christian College v. Americans United for Separation of Church and State, Inc.*, 454 U.S. 464, 471–76 (1982). *See generally* Garvey, *A Litigation Primer for Standing Dismissals*, 55 N.Y.U. L. REV. 545, 556 (1980); Note, *The Causal Nexus: What Must be Shown for Standing to Sue in Federal Courts?*, 29 U. FLA. L. REV. 250, 253 (1977).

232. *Warth v. Seldin*, 422 U.S. 490, 500 (1975); *see also* *Regional Properties, Inc. v. Financial and Real Estate Consulting Co.*, 678 F.2d 552, 560 n.14 (5th Cir. 1982); *Kirby v. United States Gov’t*, 675 F.2d 60, 64 (3d Cir. 1982).

The Supreme Court has not consistently applied the zone of interests portion of the standing test. *See* *Copper & Brass Fabricators Council, Inc. v. Department of the Treasury*, 679 F.2d 951, 953–54 (D.C. Cir. 1982) (Ginsburg, J., concurring).

233. “The doctrine of standing deals with the question of *who* may seek a particular judicial remedy.” Note, *Warth v. Seldin: Nonresidents Lack Standing to Challenge Exclusionary Zoning Laws*, 5 CAP. U.L. REV. 351, 354 (1976) (emphasis added). The evolution of the sale of business doctrine, as refined in *Sutter*, and as analyzed by Seldin, clearly shows that the main focus of the doctrine’s rationale is also not on the instrument concerned but on who is to be allowed to bring suit under the securities laws.

234. *See supra* notes 207–12 and accompanying text.

private cause of action.<sup>235</sup> Section 17(a) of the '33 Act and section 10 of the '34 Act are most commonly cited by plaintiffs in sale of business doctrine cases even though they do not contain express private causes of action. Again, assuming solely for purposes of argument that entrepreneurs are not intended beneficiaries of the securities laws, courts adopting the sale of business doctrine would be on more solid ground if they simply refused to imply a private cause of action on behalf of entrepreneurs.

If courts refuse to imply a private cause of action, the sale of business doctrine's validity becomes a moot issue. This is a possibility when actions are brought under section 17(a) of the '33 Act, because the lower courts have split concerning whether to imply a private cause of action thereunder.<sup>236</sup> A private cause of action is firmly established under section 10(b) of the '34 Act,<sup>237</sup> yet it is available only to those plaintiffs who are members of a "class for whose 'especial benefit' the statute was enacted."<sup>238</sup>

Although no evidence exists that Congress intended corporate stock to be a security to some purchasers and sellers, but not to others, it is clear the

235. The similarity between the zone of interests element of the standing test and the first of the four elements in the *Cort v. Ash* test for the implication of a private right of action has been noted elsewhere. See Garvey, *A Litigation Primer For Standing Dismissals*, 55 N.Y.U. L. REV. 545, 564, 567-68 (1980); Tushnet, *The New Law of Standing: A Plea for Abandonment*, 62 CORNELL L. REV. 663, 673 (1977). Supreme Court Justices have frequently used the terms "standing" and "right of action" interchangeably in the implied cause of action context.

For examples in which the court has interchanged the term "standing" with the term "right of action," see *Piper v. Chris-Craft Indus.*, 430 U.S. 1, 35-36, 38, 42 n.28, 43 n.31, 44, 45 (1977); *Warth v. Seldin*, 422 U.S. 490, 500 n.12, 501 (1975); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 743, 754 (1975); *id.* at 761 (Blackmun, J., dissenting); *National R.R. Passenger Corp. v. National Ass'n of R.R. Passengers*, 414 U.S. 453, 466-72 (1974) (Douglas, J., dissenting).

236. Cases that have implied a private cause of action under § 17(a) include *Kirshner v. United States*, 603 F.2d 234, 241 (2d Cir. 1978), *cert. denied*, 444 U.S. 995 (1979); *Daniel v. International Bhd. of Teamsters*, 561 F.2d 1223, 1245 (7th Cir. 1977), *rev'd on other grounds*, 439 U.S. 551 (1979); *Newman v. Prior*, 518 F.2d 97, 99 (4th Cir. 1975); *Fund of Funds, Ltd. v. Arthur Andersen & Co.*, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,751 (S.D.N.Y. 1982); *Ohio v. Crofters*, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,632 (S.D. Ohio 1981); *Kaufman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 464 F. Supp. 528, 537 (D. Md. 1978); *Valles Salgado v. Piedmont Capital Corp.*, 452 F. Supp. 853, 857 (D.P.R. 1978). Cases that have refused to imply a private cause of action under § 17(a) include *Landry v. All Am. Assurance Co.*, 688 F.2d 381, 391 (5th Cir. 1982); *Greater Iowa Corp. v. McLendon*, 378 F.2d 783, 789-91 (8th Cir. 1967); *Keys v. Wolfe*, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,802 (N.D. Tex. 1982); *Kaufman v. Magid*, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,713 (D. Mass. 1982); *Manchester Bank v. Connecticut Bank and Trust Co.*, 497 F. Supp. 1304, 1313-14 (D.N.H. 1980); *Martin v. Howard, Weil, Labouisse, Friedricks, Inc.*, 487 F. Supp. 503, 506-07 (E.D. La. 1980); *Gunter v. Hutcheson*, 433 F. Supp. 42, 45 (N.D. Ga. 1977); *Dyer v. Eastern Trust & Banking Co.*, 336 F. Supp. 890, 903 (D. Me. 1971). See also Scholl & Perkowski, *An Implied Right of Action Under Section 17(a): The Supreme Court Has Said "No," But Is Anybody Listening?*, 36 U. MIAMI L. REV. 41 (1981); Note, *Implication Under Section 17(a) of the Securities Act of 1933—The Effect of Aaron v. SEC*, 49 FORDHAM L. REV. 1161 (1981).

237. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975), in which the Supreme Court acquiesced to a 25 year line of lower court cases implying a private cause of action under § 10(b), stemming from *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946); see also *Herman & MacLean v. Huddleston*, 103 S. Ct. 683 (1983).

238. *Cort v. Ash*, 422 U.S. 66, 78 (1975) (quoting *Texas & Pac. Ry. v. Rigsby*, 241 U.S. 33, 39 (1916)) (emphasis added). This "especial benefit" language is the first element of *Cort v. Ash*'s four-part test for the implication of a private cause of action. The other three elements are (2) legislative intent, explicit or implicit, (3) consistency of the implication with the underlying purposes of the act in question, and (4) whether the area of law involved is one relegated to state law. 422 U.S. 66, 78 (1975).

The "especial benefit" element derives from *Texas & Pac. Ry. v. Rigsby*, 241 U.S. 33, 39 (1916), in which the Supreme Court held that a "disregard of the command of a statute is a wrongful act, and where it results in

Congress frequently enacts laws intending that some persons, but not others, be allowed to sue under those laws.<sup>239</sup> If the fundamental rationale of the sale of business doctrine is correct, and Congress did not mean to benefit entrepreneurs when it passed the securities laws, a much simpler way to exclude entrepreneurs would be for the court to refuse to imply a cause of action under section 10(b) on behalf of such a plaintiff.<sup>240</sup> Buried in *Sutter* is the statement: "It is doubtful that rules promulgated under section 10(b) of the Securities Exchange Act of 1934 were intended to create private rights of action at all . . . . *It is certain they were not intended to create private rights of action in favor of entrepreneurs rather than investors.*"<sup>241</sup> This conclusion is not at all certain, but, assuming its validity, the court could have stopped there. All the reasoning aimed at removing corporate stock from the definition of security was superfluous.

Promulgation of the sale of business doctrine is a tactical anomaly. Courts wishing, mistakenly, to exclude entrepreneurs from the scope of the federal securities laws have badly botched the job by taking a roundabout route through the sale of business doctrine. There is no need to attempt to disprove the obvious—that corporate stock is a security. If the securities laws are not meant to protect entrepreneurs, a mistaken notion but one prerequisite to acceptance of the sale of business doctrine, then the courts should stop there and hold that entrepreneurs have no standing to assert private causes of action under the securities laws. That courts have not taken this simple route but have muddled the issue is indicative of the basic flaws in the investor-entrepreneur dichotomy.

### C. The Registration Requirement of the '33 Act

The sale of business doctrine has been touted by Seldin as "new relief from securities regulation."<sup>242</sup> He notes that the cases do not distinguish, for purposes of determining whether a sale of business transaction involves a

damage to one of the class for whose especial benefit the statute was enacted, the right to recover damages from the party in default is implied . . . ." (emphasis added).

The Supreme Court has modified the *Cort v. Ash* approach. Since *Cannon v. University of Chicago*, 441 U.S. 677 (1979), the Court's primary focus has been on the intent of Congress, and the *Cort* elements have been applied only in light of that overriding consideration. See, e.g., *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 378-79 (1982); *Universities Research Ass'n v. Coutu*, 450 U.S. 754 (1981); *Transamerican Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979); *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979).

239. In the most recent Supreme Court implied action case, *Merrill Lynch, Pierce, Fenner & Smith Inc., v. Curran*, 456 U.S. 353 (1982), the Court had to determine whether "speculators" as well as "investors" were intended to be protected by the Commodity Futures Trading Commission Act. *Id.* at 388-90.

240. The most direct analogy is to *Piper v. Chris-Craft Indus.*, 430 U.S. 1 (1977), in which a defeated tender offeror sued for damages under the Williams Act. The Court could conceivably have used the sale of business doctrine and have said to the plaintiff: "You were intending to buy 100% of the stock and control the corporation; therefore what you were trying to buy was not a 'security' and the securities laws are inapplicable." Instead the court followed a more direct and logical route, holding that the Williams Act was meant to protect only shareholders and that, therefore, defeated tender offerors have no standing to assert a cause of action for damages under the Williams Act. *Id.* at 35-37.

241. 687 F.2d 197, 202 (7th Cir. 1982) (emphasis added). The court also touched on the concept of standing. *Id.* at 203.

242. Seldin II, *supra* note 10, at 31.

security, between antifraud violations of the '33 and '34 Acts and registration violations of the '33 Act.<sup>243</sup> Apparently, Seldin is referring to relief from the potentially burdensome registration requirements of the '33 Act. In this context application of some form of the sale of business doctrine is theoretically advantageous to buyers and sellers alike because it reduces expense and expedites the transaction.

This advantage, however, is largely illusory. Exemptions from '33 Act registration already exist for most such transactions.<sup>244</sup> Actually, very few cases that apply the sale of business doctrine even mention the registration provisions of the '33 Act,<sup>245</sup> leading one to conclude that the sale of a business doctrine is of little practical benefit in relieving the parties from burdensome '33 Act registration.

Even if evidence is adduced that the parties negotiating the sale of a business are unduly burdened by the registration provisions of the '33 Act, the sale of business doctrine is an inappropriate remedy. Congress should alter or expand the existing exemptions; courts should not take it upon themselves to declare corporate stock a nonsecurity.

If Congress does act, it is likely either to widen existing exemptions or to create new exemptions. When Congress exempted private offerings to persons whom it felt did not need '33 Act protection,<sup>246</sup> it did not say that an instrument is not a security if it is sold to someone, for example, an insider, who does not need protection. Rather, Congress provided a registration exemption. Congress has never made the error of equating or confusing the question of the existence of a security with the question "of whether the registration or approval philosophies should be invoked."<sup>247</sup> The courts adopting the sale of business doctrine make just that mistake.

#### D. A "Haven for Welshers"

Not surprisingly, few reported cases either refer to the registration issue or suggest that alternative registration exemptions are unavailable, since '33 Act registration is simply not the issue in sale of business doctrine cases.

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243. Seldin I, *supra* note 10, at 638 n.3.

244. The most appropriate exemption in sale of business cases is the private placement exemption for affiliates and controlling persons, known as the "Section 4(1½)" exemption because it requires adherence to many of the requirements for exemption under '33 Act §§ 4(1) ("transactions by any person other than an issuer, underwriter, or dealer") and 4(2) ("transactions by an issuer not involving any public offering"). See generally A Report to the Committee on Federal Regulation of Securities from the Study Group on Section "4(1½)" of the Subcommittee on 1933 Act, *The Section "4(1½)" Phenomenon: Private Resales of "Restricted" Securities*, 34 BUS. LAW. 1961 (1979).

245. In a familiar style of drawing complaints, many plaintiffs' attorneys' laundry list of sections allegedly violated includes § 5 or § 12 of the '33 Act, but the primary provisions of concern in virtually every case are the antifraud provisions, § 10(b) of the '34 Act and, less frequently, § 17(a) of the '33 Act.

246. See, e.g., the private placement exemption of § 4(2) of the '33 Act, 15 U.S.C. § 77d (2) (Supp. V 1981), applied in *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953).

247. Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 CASE W. RES. L. REV. 367, 372 (1967).

Rather, the overriding issue present in virtually all such cases is fraud, grounded on section 10(b) of the '34 Act.<sup>248</sup> Because the sale of business doctrine erects an additional legal shield for those engaged in securities fraud, it encourages that fraud.

A survey of the sale of business doctrine cases shows that the doctrine is invariably raised as a defense by persons accused of fraudulent activity.<sup>249</sup> If the defense succeeds, it relegates an allegedly defrauded plaintiff to the inferior remedies offered by a common-law fraud claim. The substantive and procedural advantages to a defrauded party of a federal securities law fraud claim over a common-law fraud claim are substantial.<sup>250</sup>

*Sutter* illustrates how the sale of business doctrine aids an alleged defrauder. In *Sutter* the trial judge dismissed the rule 10b-5 claim on sale of business doctrine grounds and certified the issue for immediate appeal.<sup>251</sup> Common-law fraud claims based on diversity of citizenship jurisdiction were retained. The Seventh Circuit reaffirmed its belief in the sale of business doctrine, but remanded the case to decide the issue of entrepreneurial versus investment intent of the plaintiff, which it viewed as the determinative issue.<sup>252</sup> The trial court must now reconsider the case to resolve this issue,<sup>253</sup> and if the plaintiff succeeds in showing investment intent, trial of the 10b-5 claim will finally follow.

Even if the plaintiff cannot establish investment intent, the diversity claim will remain because that issue was not resolved on appeal and the

248. It is indicative that the two leading cases regarding the sale of business doctrine, *Sutter v. Groen*, 687 F.2d 197 (7th Cir. 1982), and *Golden v. Garafalo*, 678 F.2d 1139 (2d Cir. 1982), are primarily concerned with § 10(b) of the '34 Act.

249. See *Sutter v. Groen*, 687 F.2d 197 (7th Cir. 1982); *Golden v. Garafalo*, 678 F.2d 1139 (2d Cir. 1982).

250. Substantive advantages of a federal rule 10b-5 claim over a state fraud claim include (1) liability of "controlling persons" under § 20(a) of the '34 Act, 15 U.S.C. § 78t(a) (Supp. V 1981); (2) no security for expenses requirement, as is found in many state derivative suit statutes, e.g., N.Y. BUS. CORP. LAW § 627 (McKinney Supp. 1972); (3) the antiwaiver provisions of § 29(a) of the '34 Act, 15 U.S.C. § 78cc(a) (Supp. V 1981); and (4) easier elements of proof, such as relaxed scienter ("recklessness" generally accepted as sufficient, e.g., *Hackbart v. Holmes*, 675 F. 2d 1114, 1117 (10th Cir. 1982)), reliance (*Affiliated Ute Citizens v. United States*, 406 U.S. 128, 150-54 (1972)), and privity (*Sargent v. Genesco, Inc.*, 492 F.2d 750, 759-61 (5th Cir. 1974)) requirements.

Procedural advantages of the federal forum include (1) a wide choice of venue stemming from § 27 of the '34 Act, 15 U.S.C. § 78aa (Supp. V 1981); (2) world-wide service of process, *id.*; (3) more liberal pleading, joinder, and discovery provisions of the Federal Rules of Civil Procedure; and (4) possibly a longer statute of limitations.

See generally Hammett, *Any Promissory Note: The Obscene Security—A Search for the Non-Commercial Investment*, 7 TEX. TECH L. REV. 25, 30-35 (1975); Comment, *A Pledge of Stock in a Commercial Loan: "Purchase or Sale" Under the Securities Exchange Act of 1934?*, 1979 ARIZ. ST. L.J. 669, 670-71; Comment, *Commercial Notes and Definition of 'Security' Under Securities Exchange Act of 1934: A Note is a Note is a Note?*, 52 NEB. L. REV. 478, 503-10 (1973).

251. *Sutter v. Groen*, 687 F.2d 197, 199 (7th Cir. 1982); see FED. R. CIV. P. 54(b).

Because the state courts are heavily influenced by the action of federal courts, widespread acceptance of the sale of business doctrine at the federal level would probably mean that state securities laws will be similarly construed, thus eliminating any blue sky protection for defrauded purchasers and sellers of controlling blocks of corporate stock. Karjala, *Realigning Federal and State Roles in Securities Regulation Through the Definition of a Security*, 1982 U. ILL. L. REV. 413, 415.

252. 687 F.2d 197, 203-04 (7th Cir. 1982).

253. This will not be an easy determination to make. See *infra* notes 285-97 and accompanying text.

plaintiffs continue to assert that Groen is a citizen of California.<sup>254</sup> Assuming diversity is found, and defendant does not appeal again, trial will follow in federal court on the substantive issue in dispute. The net effect of the sale of business doctrine is to give the alleged defrauder a tool to delay interminably any determination of his ultimate liability. At this writing the case has already been on file for twenty-two months, with no resolution on the merits in sight.<sup>255</sup>

In addition to providing fraud defendants with a potent tool for obfuscation and delay, the sale of business doctrine rests upon the patently erroneous assumption that purchasers and sellers of controlling blocks of stock do not need federal antifraud protection to the same extent as investors. Two reasons are commonly given for this assumption.

First, entrepreneurs do not need the protection because they intend to actively operate the business themselves.<sup>256</sup> In the typical sale of business scenario, however, the plaintiff is a defrauded purchaser who has been led to believe that the business purchased is worth more than it actually is. The fraud and the harm occur at the time of the sale, before the purchaser-plaintiff exerts any control over the business. In this sense a buyer of 100 percent of the stock of a corporation is injured in the same manner as the purchaser of 1 percent. The only distinction is that the purchaser of control has suffered 100 times the injury and, therefore, needs securities law protection even more.<sup>257</sup>

Sale of business doctrine courts are fond of saying that form should not be exalted over substance in determining whether the federal securities laws should apply to a transaction.<sup>258</sup> In every case, whether plaintiff purchases 1 percent or 100 percent of a company's stock, the shares of stock are worthless. Only the assets, goodwill, and earnings potential represented by the

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254. Telephone interviews with plaintiff's attorney Richard L. Steagal of Peoria, Illinois (Nov. 1, 1982; May 2, 1983).

255. The original suit in *Sutter* was filed on September 24, 1981. Summary judgment was granted on November 18, 1981. The Court of Appeals issued its opinion on August 20, 1982, and as of this writing the jurisdictional issue has not yet been resolved. A jurisdictional hearing is tentatively scheduled for May 23, 1983. At present three days of depositions yielding over 300 hundred pages of testimony have already been taken in preparation for this hearing.

256. Thompson, *The Shrinking Definition of a Security: Why Purchasing All of a Company's Stock Is Not a Federal Security Transaction*, 57 N.Y.U. L. REV. 225, 244 (1982) (quoting *Tech Resources, Inc. v. Estate of Hubbard*, 246 Ga. 583, 585, 272 S.E.2d 314, 317 (1980)).

257. See *Occidental Life Ins. Co. v. Pat Ryan & Assocs., Inc.*, 496 F.2d 1255, 1263 (4th Cir.), cert. denied, 419 U.S. 1023 (1974) ("The fact that Associates purchased all of the outstanding stock of Virginia Surety, rather than a small fractional share, cannot serve as a basis for granting or denying coverage under Section 10(b)."); *Alna Capital Assocs. v. Wagner*, 532 F. Supp. 591, 602 (S.D. Fla. 1982) ("[T]he prohibition of fraudulent securities transactions must apply to large purchasers as well as small purchasers."); see also Comment, *The Sale of a Close Corporation*, *supra* note 12, at 762 ("Indeed, the purchaser of a large block of stock is perhaps in greater need of such protection since he stands to lose more by relying on the information disclosed or withheld.").

Rapp makes the same point—that someone buying 100% of the stock of a corporation is, by gaining control, controlling only one of the many elements leading to ultimate success or failure. The right to exercise future managerial control is meaningless if the seller has misrepresented the financial condition of the enterprise prior to sale. Rapp, *supra* note 12, at 607-08, 612, 619, 621.

258. *Canfield v. Rapp & Son, Inc.* 654 F.2d 459, 465-66 (7th Cir. 1981); *Fox v. Ehrmantraut*, 28 Cal. 3d 127, 615 P.2d 1383, 167 Cal. Rptr. 595 (1980).



stock have value. For this reason the sale of business doctrine states the obvious when it equates the purchase of 100 percent of the stock of a corporation with a purchase of all the corporation's assets.<sup>259</sup>

The purchaser of 1 percent of the stock of a corporation is buying a 1/100th interest in the assets of the corporation. If that purchaser is induced to buy the stock by fraudulent misrepresentations, no one would question the applicability of the antifraud provisions of the securities laws. When the purchaser of a 100 percent interest has been induced to act by similar fraudulent misrepresentations, the antifraud provisions should also apply because the control that this purchaser intends to ultimately exercise has no bearing on the injury sustained. The injury is sustained before the purchaser has a chance to exercise control.

Sensing the essential irrelevance of this control element in the standard sale of business case format, a second rationale is advanced for excluding buyers and sellers of control from the protection of the antifraud provisions of the Securities Acts. This supplementary argument is that purchasers of control do not "need" protection.<sup>260</sup> This argument assumes that although a purchaser of one percent of a company's stock may be uninformed and unsophisticated, the purchaser or seller of control has sufficient economic leverage to protect himself by requiring adequate disclosure of pertinent information. This assumption has several flaws.

First, even the powerful and sophisticated can be deceived by intentional misrepresentations;<sup>261</sup> even corporate insiders may be the victims of deception.<sup>262</sup> A buyer's economic leverage, even though sufficient to require a seller to produce corporate records before consummation of a sale, does not prevent the seller from doctoring those records. An insider's knowledge of the business does not erect a protective shield preventing fraud. Consider again the *Kardon* case, in which two holders of fifty percent of the corporation's shares negotiated a secret sale of the business and bought out the two holders of the other fifty percent at a great profit simply by concealing the new

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259. See Comment, *Securities Regulation*, *supra* note 123, at 129-30.

260. *Condux v. Neldon*, 83 Ill. App. 3d 575, 578, 404 N.E.2d 523, 526 (1980). See also *Golden v. Garafalo*, 678 F.2d 1139, 1149 (2d Cir. 1982) (Lumbard, J., dissenting); *Alberto-Culver Co. v. Scherk*, 484 F.2d 611, 617 (7th Cir. 1973), *rev'd on other grounds*, 417 U.S. 506 (1974). See generally Comment, *Acquisition of Businesses Through Purchase of Corporate Stock: An Argument for Exclusion from Federal Securities Regulation*, 8 FLA. ST. U. L. REV. 295, 311 (1980); Note, *Sale of Business by Transfer of 100% of Corporate Stock Not Governed by Securities Laws*, 65 MARQ. L. REV. 487, 498 (1982).

261. *Lehigh Valley Trust Co. v. Central Nat'l Bank*, 409 F.2d 989, 992 (5th Cir. 1969). Problems of fraud are exacerbated in the sale of a close corporation (the typical sale of business scenario), because "[t]hese are obvious instances of natural dependence by one party on the other for information affecting value." 1 A. BROMBERG & L. LOWENFELS, *SECURITIES FRAUD & COMMODITIES FRAUD* ¶ 4.6(110) (1982). The "economic leverage" of a buyer may be of little avail, because in many small corporations "the seller-owner's records are . . . incomplete, lost, or inaccurate . . ." 1 J. HERZ & C. BALLER, *BUSINESS ACQUISITIONS* ¶ 1.203a (2d ed. 1981). This fact relegates the potential buyer to dependence upon the seller's possibly fraudulent representations.

262. A sterling example is the deception practiced on plaintiff McGrath in *McGrath v. Zenith Radio Corp.*, 651 F.2d 458 (7th Cir. 1981). Despite his high insider status, McGrath was powerless to detect that Zenith had changed its mind concerning its future plans for his employment.

opportunity.<sup>263</sup> Also illustrative is *Touche Ross*, in which the Second Circuit considered whether a note should be defined as a security. The plaintiff argued that a bank should be able to protect itself in securities dealings because of its economic leverage. Judge Friendly pointed out that "the target of §§ 10(b) of the 1934 Act and 17(a) of the 1933 Act is fraud, which a bank's ability to obtain disclosure cannot always prevent."<sup>264</sup>

Even the powerful and sophisticated are entitled to the truth;<sup>265</sup> the cases are legion in recognizing that those persons are also intended beneficiaries of the antifraud provisions of the Federal Securities Acts.<sup>266</sup> Although Congress may have decided that for registration purposes of the '33 Act, sophisticated purchasers can protect themselves,<sup>267</sup> the '33 Act exemptions apply only to registration requirements. The antifraud provisions of the '33 and '34 Acts are unaffected by these exemptions.<sup>268</sup>

The sale of business doctrine errs again by equating the presence or absence of a security with the interested party's need for protection. "It is improper to equate the question of whether an arrangement constitutes a security with the question of whether" the protections of the securities laws are required.<sup>269</sup> For example, when Congress decided that sales of stock to a few sophisticated buyers who could look after themselves need not be registered under the '33 Act, it did not provide that the stocks would not be

263. *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947). For similar scenarios, see *Stacey v. Charles J. Rogers, Inc.*, 542 F. Supp. 48 (E.D. Mich. 1982); *Barsy v. Verin*, 508 F. Supp. 952 (N.D. Ill. 1981); and *Bronstein v. Bronstein*, 407 F. Supp. 925 (E.D. Pa. 1976).

264. 544 F.2d 1126, 1137 (2d Cir. 1976).

265. *Wheat v. Hall*, 535 F.2d 874, 876 (5th Cir. 1976); *Nor-Tex Agencies, Inc. v. Jones*, 482 F.2d 1093, 1099 (5th Cir. 1973), *cert. denied*, 415 U.S. 977 (1974).

266. *SEC v. Dolnick*, 501 F.2d 1279, 1283 (7th Cir. 1974); *Nor-Tex Agencies, Inc., v. Jones*, 482 F.2d 1093, 1099 (5th Cir. 1973), *cert. denied*, 415 U.S. 977 (1974); *Steir v. Smith*, 473 F.2d 1205, 1207 (5th Cir. 1973); *Hanly v. SEC*, 415 F.2d 589, 596 (2d Cir. 1969); *Carroll v. First Nat'l Bank*, 413 F.2d 353, 357 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970); *Lehigh Valley Trust Co. v. Central Nat'l Bank*, 409 F.2d 989, 992 (5th Cir. 1969); *Credit & Fin. Corp. v. Warner & Swasey Co.*, 517 F. Supp. 134, 135 n.1 (S.D.N.Y. 1981); *Altschuler v. Cohen*, 471 F. Supp. 1372, 1383 (S.D. Tex. 1979); *Rolf v. Blyth Eastman Dillon & Co.*, 424 F. Supp. 1021, 1037 (S.D.N.Y. 1977); *Welch Foods Inc. v. Goldman, Sachs & Co.*, 398 F. Supp. 1393, 1398-99 (S.D.N.Y. 1974); *Barthe v. Rizzo*, 384 F. Supp. 1063, 1067 (S.D.N.Y. 1974); *Newman v. Shearson, Hammill & Co.*, 383 F. Supp. 265, 268 (W.D. Tex. 1974); *In re Scientific Control Corp. Sec. Litig.*, 71 F.R.D. 491, 512 (S.D.N.Y. 1976).

267. Professor Long has noted:

It is totally irrelevant for security classification purposes whether the holder of the interest does in fact share in these decisions due to some other relationship with the enterprise. Thus stock owned by a director or officer of a corporation does not cease to be a security because the officer or director has a right by virtue of his official position to share in the policy-making process. The fact that he holds such a position and by virtue of it has access to much of the material he would receive through the registration process may be significant in determining whether to exempt sales to him from the registration process, but it is irrelevant in the determination of whether the interest sold is a security.

Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 173 (1971).

268. *Ballard & Cordell Corp. v. Zoller & Danneberg Exploration, Ltd.*, 544 F.2d 1059, 1064 (10th Cir. 1976); *Nor-Tex Agencies, Inc. v. Jones*, 482 F.2d 1093, 1099 (5th Cir. 1973), *cert. denied*, 415 U.S. 977 (1974); *Spatz v. Borenstein*, 513 F. Supp. 571, 577 (N.D. Ill. 1981); *Sohns v. Dahl*, 392 F. Supp. 1208, 1218-19 (W.D. Va. 1975).

269. Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 CASE W. RES. L. REV. 367, 372 (1967).

securities in that context. Assuming that the stocks would remain securities, it enacted exemptions from registration.<sup>270</sup> As Professor Coffey has noted:

[I]t cannot be said that an arrangement is not a security just because it is offered to only a few fully informed and sophisticated buyers so as to be exempt from registration or state approval. By their structure, the securities laws clearly imply that the features of a transaction which dictate the requirement for registration or state approval are distinct from, and in addition to, the criteria employed in deciding the prior and more basic question of security *vel non*.<sup>271</sup>

Another problem with the "they can protect themselves" view is that it requires purchasers and sellers of control to be extraordinarily circumspect and suspicious, possibly stultifying normal commercial transactions. The buyer or seller of control is told that he cannot rely on the honesty of those with whom he deals. Yet, the Third Circuit held that

a sophisticated investor is not barred by reliance upon the honesty of those with whom he deals in the absence of knowledge that the trust is misplaced. Integrity is still the mainstay of commerce and makes it possible for an almost limitless number of transactions to take place without resort to the courts.<sup>272</sup>

Courts concerned with denying federal securities law protection to parties who are able to protect themselves, but do not, should reject the sale of business doctrine and concentrate on development of the due diligence defense. For example, in *DuPuy v. DuPuy*,<sup>273</sup> which concerned the sale of a controlling interest in a business, plaintiff Milton claimed that his brother Clarence defrauded him into selling to Clarence his forty-seven percent interest in a corporation for an inadequate sum.<sup>274</sup> Clarence also owned forty-seven percent of the stock, and their mother owned the remaining six percent. Milton took an active role in the business, and the sale of business doctrine would probably have barred his action on grounds that the stock he sold was not a security.<sup>275</sup> The Fifth Circuit's discussion of Milton's federal security

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270. In § 4(2) of the '33 Act, for example, Congress provides that the registration provisions of § 5 should not apply to "transactions by an issuer not involving any public offering." 15 U.S.C. § 77d (Supp. V 1981). When the Supreme Court attempted to define the scope of this exemption vis-à-vis an employee stock option plan in *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953), the Court never even hinted that if certain high corporate officials were offered stock options, that stock would not constitute a security. Rather, the obvious conclusion was that the stock would still be a security, but it need not be registered because of the exemption.

271. Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 CASE W. RES. L. REV. 367, 372 (1967). Professor Long made the same point when talking about shares held by officers and directors, arguing that the position of the holder as one participating in the management and control of the corporation does not alter the nature and classification of his shares as securities. Long, *Introduction: Definition of a Security*, 6 ST. MARY'S L.J. 96, 120 (1974). In a footnote Long went on to note that the status of a shareholder as a director or officer "may be significant as to whether the registration procedure is necessary as to this individual and whether the sale to him should be an exempt transaction, however, it should not alter the status of his shares as securities." *Id.* n.113. The sale of business doctrine makes just this mistake. See also Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 173 (1971).

272. *Straub v. Vaisman & Co.*, 540 F.2d 591, 598 (3d Cir. 1976).

273. 551 F.2d 1005 (5th Cir. 1977).

274. *Id.* at 1012.

275. *Id.* at 1008-09.

law claims assumed that the stock was a security, but enunciated, as a precondition to recovery, a due diligence defense that required Milton to show that he had not been reckless in engaging in the transaction.<sup>276</sup> In a later case the Fifth Circuit held that a showing of justifiable reliance by a plaintiff "is a precondition to recovery and is frequently characterized as a requirement that the plaintiff show he acted with due diligence."<sup>277</sup> Development of the due diligence doctrine should allay any fears that the federal securities laws will be used to rescue persons who are able, but nevertheless neglect, to protect themselves.

Utilizing the sale of business doctrine to remove the federal securities laws' antifraud protection from those who need and are entitled to it borders on the scandalous. Appallingly, Seldin exacerbates use of the doctrine as a shield for fraud by outlining elaborate drafting guidelines that potential buyers and sellers can employ to ensure that they come within the scope of the sale of business doctrine.<sup>278</sup> This may be the only situation in which a party can effectively extinguish, through careful drafting, a remedy (section 10(b)) otherwise available to him. For example, assume *L*, an attorney, is representing *B*, a prospective purchaser of a business from *S*. *S* is represented by *X* and has made material misrepresentations to *B* concerning the financial position of the business. The transaction is characterized as a stock sale, and *L* and *X*, following Seldin's advice, draft the parties into the sale of business exception. The fraud is later discovered, and *B* sues *S* under rule 10b-5. *S* asserts the sale of business doctrine as a defense; in many circuits today he would prevail.<sup>279</sup> The same result follows in a suit by *S* for fraud perpetrated by *B*. Both attorneys have done their clients a disservice. Since neither counsel knows at the time the contract is drafted that the client is guilty of fraud, both run the risk that they are drafting their clients out of a valuable federal remedy and, consequently, risk malpractice claims.

The problem of counterproductive contract drafting is illustrated by Seldin's approach to whether the sale of business doctrine should apply to

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276. *Id.* at 1013-20.

277. *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1121-22 (5th Cir. 1980); *see also* *White v. Sanders*, 689 F.2d 1366, 1369 (11th Cir. 1982); *Petrites v. J. C. Bradford & Co.*, 646 F.2d 1033, 1035 (5th Cir. 1981); *Gower v. Cohn*, 643 F.2d 1146, 1156-57 (5th Cir. 1981); *G. A. Thompson & Co. v. Partridge*, 636 F.2d 945, 954 (5th Cir. 1981).

In the wake of *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), which requires a plaintiff to show scienter to recover for a rule 10b-5 violation, some question does arise about the status of the due diligence defense, even though *DuPuy* does remain the leading case. *See* *J.H. Cohn & Co. v. American Appraisal Assocs., Inc.*, 628 F.2d 994, 999 n.4 (7th Cir. 1980). *But see* *Holdsworth v. Strong*, 545 F.2d 687, 693 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977). *See generally* R. JENNINGS & H. MARSH, *SECURITIES REGULATION: CASES AND MATERIALS* 1071-73 (5th ed. 1982); Wheeler, *Plaintiff's Duty of Due Care Under Rule 10b-5: An Implied Defense to an Implied Remedy*, 70 NW. U. L. REV. 561 (1975); Comment, *Section 10(b) and Rule 10b-5—Plaintiff's Exercise of Due Diligence Is to Be Measured by a Recklessness Standard*, 9 RUT.-CAM. L.J. 598 (1978); Note, *Due Diligence—A Plaintiff's Failure to Exercise Care Does Not Bar His Recovery in a Rule 10b-5 Action for Damages Unless He Acted with Reckless Disregard of Material Facts Surrounding the Securities Transaction*, 12 GA. L. REV. 112 (1977).

278. Seldin II, *supra* note 10, at 36-37.

279. *See supra* notes 16-83 and accompanying text.

sales of less than 100 percent of the stock of a transferred business. Seldin proposes that the doctrine should apply on a case-by-case basis to less than 100 percent purchases if the purchaser acquires "a sufficient stockholding interest to actually control all of the management decisions respecting the company."<sup>280</sup> He rejects a rigid 100 percent test because of the common possibility that control may be established in many cases through much smaller purchases and because

if it became known that the applicability of the doctrine would depend on whether all or less than all of the stock was purchased, it is conceivable that there would develop a practice of *ritualistic posturing* between potential purchasers and sellers, each trying to preserve or preclude federal securities law remedies in connection with the transaction, depending on his interests.<sup>281</sup>

Nevertheless, Seldin advocates such "ritualistic posturing" in his collection of suggested contract provisions designed to assure invocation of the doctrine.<sup>282</sup> He speaks of attempts by the parties to "preserve or preclude federal securities law remedies."<sup>283</sup> One may very well ask why a purchaser or seller of stock would want to destroy voluntarily a valuable federal remedy otherwise available to him, protecting him against the other's fraud. Or perhaps more pointedly: Why would a purchaser or seller want to destroy a valuable federal fraud remedy otherwise available to the other party? The answer is apparent since the sale of business doctrine is used in virtually all cases as a defense asserted by a person allegedly liable for fraud in connection with the purchase or sale of corporate stock. It is doubtful that Congress intended the Securities Acts' most basic definition, "security," to be construed to provide such a haven for fraud defendants.

#### E. *A Burden on the Federal Courts*

The sale of business doctrine's excessively crabbed view of the protective coverage of the antifraud provisions might be justifiable if the doctrine delivered on its promise to reduce the caseloads of the federal courts.<sup>284</sup> The practical difficulties in applying the doctrine, however, may dictate an increased burden on the courts.

As discussed earlier, the sale of business doctrine simply produces another technicality for the defrauder to hide behind, resulting in additional rounds of hearings and appeals.<sup>285</sup> Beyond this problem, added difficulties arise because the "contours of the sale of business doctrine are unclear,"<sup>286</sup> a fact necessarily resulting from the doctrine's inherent "elusiveness as a legal

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280. Seldin I, *supra* note 10, at 679.

281. *Id.* at 678 (emphasis added).

282. Seldin II, *supra* note 10, at 36-37.

283. Seldin I, *supra* note 10, at 678.

284. *See supra* note 225.

285. *See supra* notes 251-55 and accompanying text.

286. *Golden v. Garafalo*, 678 F.2d 1139, 1145 (2d. Cir. 1982).

concept."<sup>287</sup> A major part of this "elusiveness" stems from the difficulty in discerning whether the buyer has the intent to manage the business. This critical consideration in the doctrine's application "is a very difficult issue to resolve on the basis of conflicting, self-serving testimony. It will, moreover, raise countless issues of application of the legal rules to particular facts."<sup>288</sup>

To illustrate these difficulties, the *Garafalo* court used *Poloway*,<sup>289</sup> a seminal sale of business doctrine case. In *Poloway* the defendant-seller entered into an employment agreement with the buyer to "assist, guide, and give his expertise" in all areas of the business for five years for an annual salary plus commissions, which "looked suspiciously like a right to share in the profits."<sup>290</sup> The underlying agreement vested total management and operation of the business in the plaintiff, even though he had no expertise in that type of business and later asserted that he relied completely upon defendant's managerial efforts and expertise. Because the plaintiff had the ultimate right of control, at least in theory, the court applied the sale of business doctrine, thereby affirming dismissal of the plaintiff's federal securities law claim. This result was criticized in *Garafalo*.<sup>291</sup> Even a staunch supporter of the doctrine admits that *Poloway* presented "a close, and possibly questionable, factual judgment."<sup>292</sup>

A similar problem arose in *Sutter*, in which the plaintiff's immediate right to manage was explicitly stated in the stock purchase agreement.<sup>293</sup> Nevertheless, the plaintiff continues at present to staunchly assert that the doctrine should not apply because the purchase was made as an investment.<sup>294</sup> On remand to the district court the issue of investment versus entrepreneurial intent promises to be hotly contested.

Further, *Sutter*'s presumption that a purchaser of more than fifty percent of the stock in a corporation bought with entrepreneurial intent is neither satisfying nor particularly helpful in resolving such issues. Corporations are frequently controlled by owners of less than fifty percent of the outstanding shares, as the *Garafalo* court pointed out:

Discarding intent to manage and focusing on transfers of control—which for these purposes can be defined as actual power to select the management—does not reduce the doctrine's elusiveness when applied to particular facts. In "economic reality," considerably less than 100% and often less than 50% of outstanding shares may be a controlling block which, when sold to a single holder, ef-

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287. *Id.* Another commentator has described the case-by-case definitional approach fostered by the sale of business doctrine as "confusing." Seymour, *A Sleeping Dragon Awakes: The Federal Securities Laws Apply to One and Two-Man Corporations*, 53 OKLA. B.J. 2531, 2534 (1982).

288. 678 F.2d 1139, 1145 (2d Cir. 1982).

289. 637 F.2d 1147 (7th Cir. 1981).

290. *Golden v. Garafalo*, 678 F.2d 1139, 1145 (2d Cir. 1982).

291. *Id.*

292. Seldin I, *supra* note 10, at 648.

293. 687 F.2d 197, 198 (7th Cir. 1982).

294. Telephone interviews with plaintiff's attorney Richard L. Steagal of Peoria, Illinois (Nov. 1, 1982; May 2, 1983).

fectively transfers the power to manage the business. Actual control depends upon number and dispersal of shareholders, whether they be individuals, other businesses or institutional investors, and a variety of other facts which render control a most uncertain test.<sup>295</sup>

Thus, although a purchaser acquiring control through a thirty percent stock purchase will have the benefits of *Sutter*'s presumption, and thus the continued protection of the federal securities laws, a sixty percent purchaser for investment will bear the burden of proving his investment intent. Of course, as already noted,<sup>296</sup> the size of a stock purchaser's investment is not determinative of his need for protection. It is anomalous that purchasers of minute percentages of corporate stock on national exchanges are unquestionably protected under federal securities laws, while the sale of business doctrine eliminates antifraud protection for purchasers of a controlling block who obviously have much more to lose if deceived.

The presumption's rebuttable nature means that it is of little practical assistance to the courts. The presumption does not dispose of the issue of investment intent; it merely shifts the burden of proof regarding the question of "dominant purpose." This will not be an easy matter to resolve, given the conflicting and self-serving testimony that can be expected from the parties. Furthermore, the notion that a court must "delve into the workings of a validly existing business corporation and the relationship of the shareholders, just to make the threshold determination of the jurisdiction."<sup>297</sup> has been rejected. Resolving the issue requires yet another complex judicial proceeding that increases the expense of the litigation, imposes an added burden on the federal courts, reduces predictability in securities law administration, and delays further resolution of the basic issues in dispute. More hearings, more appeals, and more delays are the legacy of the sale of business doctrine.

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295. 678 F.2d 1139, 1146 (2d Cir. 1982); see also Note, *Purchase of Stock*, *supra* note 12, at 1254.

The various considerations that define the concept of control—percentage of shares owned, dispersion of shares, existence of voting agreements—that are referred to in *Garafalo* make the determination of control so "slippery" that although the SEC has promulgated a broad definition of "control," 17 C.F.R. § 230.405(f) (1982), it has consistently refused to render opinions to individuals inquiring whether they may be held a "controlling person." SEC Interpretive Release No. 33-6253, 45 Fed. Reg. 72,644 (1980) (to be codified at 17 C.F.R. pt. 231).

While *Sutter* sets up a rebuttable presumption of control at the 50% level, the Proposed Federal Securities Code would establish a rebuttable presumption of control at 25%. FED. SEC. CODE § 202(29)(B) (1980).

296. See *supra* note 257 and accompanying text. The Fourth Circuit's statement in *Occidental Life Ins. Co. v. Pat Ryan & Assocs., Inc.*, 496 F.2d 1255 (4th Cir.), *cert. denied*, 419 U.S. 1023 (1974) is worth quoting in full:

The application of Section 10(b) cannot depend on whether the purchaser of stock buys a small interest, a controlling interest, or all of the stock, of a corporation. Such a standard would be difficult to apply and create a capricious basis for dispensing the protection of Section 10(b). The Court finds no reason for reading the Securities Exchange Act in a manner that provides coverage of the small investor, but not the large one. Such a construction would fly in the face of the remedial purposes of the Act. In one sense the large investor has a more pressing need for protection to the extent that he has expended a greater amount of his resources.

*Id.* at 1263.

297. *Bronstein v. Bronstein*, 407 F. Supp. 925, 929 (E.D. Pa. 1976); see also Note, *Purchase of Stock*, *supra* note 12, at 1254-55; Comment, *The Sale of a Close Corporation*, *supra* note 12 at 765.

## V. CONCLUSION

Given the broad remedial purposes of the federal securities laws,<sup>298</sup> the sale of business doctrine should be rejected. At a theoretical level, the doctrine is flawed because no acceptable rationale for circumventing the clear wording and intent of Congress that stock be considered a security has been developed. Nor has any authority effectively demonstrated that purchasers and sellers of control do not need the protection of the antifraud provisions of the '33 and '34 Acts or that they were not intended beneficiaries of those Acts. The ramifications of the sale of business doctrine, for example, the notion that stock is a security for some persons and purposes but not for others, are admittedly curious and are more accurately described as bizarre.

On a practical level, the sale of business doctrine operates to protect wrongdoers, hinders the defrauded party seeking relief, and burdens the federal courts. All these results occur with no countervailing benefit to effectuate the purposes of the securities laws.

When a court defies the words of Congress, and common sense as well, by holding that corporate stock is not a security, it goes too far in closing the federal courthouse doors to fraud claims arising out of transactions in securities. Given its inherent conflict with prior law, statutory language and policy, and its difficulties in application, the Supreme Court should, when given the opportunity, mercifully inter the sale of business doctrine.

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298. Courts adopting the sale of business doctrine would do well to read Judge Gibbons' words in *Weaver*:

A few words are appropriate with respect to the district court's approach to the proper interpretation of the Securities Act of 1934. Throughout the court's opinion granting summary judgment there is a general tone of nostalgia for the days when victims of fraud were relegated to the common law remedy of deceit, and when such actions were tried in state courts under state law standards. This interpretation of the Act is grudging of coverage and is fundamentally at variance with the decision made by Congress in 1934 to place a *national* floor under the level of conduct to which parties dealing in the national investment market might descend. The 1934 Act defines securities so broadly as to include virtually every transaction in which an investor might expect to receive a return on his money. It proscribes misconduct not in terms merely of common law fraud subject to all the vagaries of state law, but in the all-inclusive terms "manipulative acts and practices in connection with a purchase or sale" of a security. Most significantly, it provides in section 27 of the Act, 15 U.S.C. § 78aa, one of those comparatively rare instances in which federal jurisdiction is made exclusive. *The message is clear that the federal courts have been given a very special responsibility for overseeing the level of permissible conduct in securities transactions.* The reason for the congressional decision is equally clear considering the doleful pre-1934 history of securities transactions during which Congress, dependent upon state common law remedies for regulation of the level of conduct in securities transactions, watched standards of fiduciary duty and of representation in the market place descend to the level tolerated in the most tolerant jurisdiction. Given the special responsibility entrusted to them, the federal courts ought to interpret the 1934 Act with a presumption of coverage of any transaction which Congress did not expressly exclude. This is especially so when it is remembered that the state courts cannot enforce section 10(b), and thus that the Supreme Court will lack appellate jurisdiction to consider, when a trial is finally concluded in a state court, whether the underlying transaction offended national policy. 28 U.S.C. § 1257.

*Weaver v. Marine Bank*, 637 F.2d 157, 165 (3d Cir. 1980), *rev'd*, 455 U.S. 551 (1982) (emphasis added).